MISCELLANEOUS REVENUE ISSUES

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Miscellaneous Revenue Issues, Seria...

HEARINGS

BEFORE THE

SUBCOMMITTEE ON SELECT REVENUE MEASURES

OF THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

ONE HUNDRED THIRD CONGRESS

FIRST SESSION

JUNE 17, 22, 24; JULY 13, 1993; AND SEPTEMBER 8, 21, 23, 1993

PART 1 OF 3

JUNE 17, 22, 24; AND JULY 13, 1993

Serial 103–63

Printed for the use of the Committee on Ways and Means

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MISCELLANEOUS REVENUE ISSUES

THURSDAY, JUNE 17, 1993

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
SUBCOMMITTEE ON SELECT REVENUE MEASURES,
Washington, D.C.

The subcommittee met, pursuant to call, at 10:15 a.m., in room 1100, Longworth House Office Building, Hon. Charles B. Rangel (chairman of the subcommittee) presiding.

[The press releases announcing the hearings follow:]

FOR IMMEDIATE RELEASE
WEDNESDAY, JUNE 2, 1993

PRESS RELEASE #4
SUBCOMMITTEE ON SELECT REVENUE MEASURES
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
1102 LONGWORTH HOUSE OFFICE BUILDING
WASHINGTON, D.C. 20515
TELEPHONE: (202) 225-1721

THE HONORABLE CHARLES B. RANGEL (D., N.Y.), CHAIRMAN, SUBCOMMITTEE ON SELECT REVENUE MEASURES, COMMITTEE ON WAYS AND MEANS, U.S. HOUSE OF REPRESENTATIVES, ANNOUNCES A PUBLIC HEARING ON MISCELLANEOUS REVENUE ISSUES

The Honorable Charles B. Rangel (D., N.Y.), Chairman, Subcommittee on Select Revenue Measures, Committee on Ways and Means, U.S. House of Representatives, announced today that the Subcommittee will hold a series of public hearings on miscellaneous revenue issues. The first hearing will be held on Thursday, June 17, 1993, beginning at 10:00 a.m., in the main Committee hearing room, 1100 Longworth House Office Building. Additional hearing days will be announced at a later date.

In announcing the hearings, Chairman Rangel stated: "The Subcommittee looks forward to an informative set of hearings on these miscellaneous revenue issues. Because of the interest of the Members in these issues, I hope that we can proceed expeditiously with these hearings."

BACKGROUND

Members of the Committee on Ways and Means have indicated an interest in various miscellaneous revenue issues to Committee Chairman Dan Rostenkowski (D., Ill.). On May 27, 1993, Chairman Rostenkowski referred certain of these issues to the Subcommittee on Select Revenue Measures for purposes of hearings. The issues referred for hearings generally contain those not included in either the House-passed version of H.R. 11, the Revenue Act of 1992, or the miscellaneous bills that passed the House last year and that were included in the conference agreement on H.R. 11.

In addition, issues relating to the recently-passed reconciliation bill are not part of the referral to the Subcommittee, but rather, are being reserved for conference consideration. Non-tax issues in which Members have expressed an interest will be the subject of separate consideration.

The first day of hearings (June 17, 1993), will be limited to the issues described in the first section below. The remainder of the issues described in this press release will be the subject of hearings on dates to be announced.

The Subcommittee is also announcing a hearing on miscellaneous health-related issues in a separate press release (see press release #3).

Members of the Committee also have suggested various revenue-raising provisions to ensure that these miscellaneous issues could be legislated on a revenue-neutral basis. Hearings on those proposals, and on additional miscellaneous issues, will be announced at a later date.

I. ITEMS SCHEDULED FOR JUNE 17 HEARING

TAX ACCOUNTING

1. H.R. 846, a bill to permit water utilities and sewage-control facilities to exclude qualified contributions in aid of construction from gross income.

2. A proposal to modify the uniform capitalization rules to allow current deductibility of costs associated with replanting vineyards infested with the phylloxera louse and to clarify the application of the current-law exception for expenses pertaining to natural disasters.

(MORE)

3. A bill to provide that any adjustment under Internal Revenue Code (Code) section 481 (attributable to Revenue Ruling 90-65, relating to non-depreciability of precious metals fabricated into items used in a taxpayer's trade or business) be prospective only.

FINANCIAL INSTITUTIONS

1. A proposal to provide certain tax incentives to minority-owned financial institutions that acquire a failed financial institution from the Resolution Trust Corporation or Federal Deposit Insurance Corporation, including carryover of net operating losses from the failed institution and a limited deduction for equity investments in such minority-owned institutions (up to $50,000 per year and $250,000 in a lifetime for each individual investor).

2. A proposal to permit tax-free conversion of a bank common trust fund to one or more proprietary or non-proprietary mutual funds.

3. A proposal to treat small commercial finance companies like small banks for purposes of Code section 585 (relating to the reserve method of deducting bad debts).

4. A proposal to clarify the tax treatment of consolidations of life insurance departments of mutual savings banks and to assure that the 12-year dividend payout is treated as a deductible policyholder dividend.

5. H.R. 2065, a bill to provide certain tax treatment to financial asset securitization investment trusts (and similar proposals).

INSURANCE

1. A proposal to allow the deduction available to small life insurance companies to be used when calculating a small company's adjusted current earnings for purposes of the alternative minimum tax and to exempt certain small companies (i.e., companies with annual statement surplus and capital of less than $25 million and specified policy acquisition costs of less than $4 million annually) from the requirement under Code section 848 to capitalize insurance policy acquisition expenses.

2. H.R. 1416, a bill to include liability to pay compensation under workmen's compensation acts within the rules under Code section 130 relating to certain personal injury liability assignments.

3. H.R. 1228, a bill to modify the tax treatment of effectively connected investment income of foreign life insurance companies operating in the United States.

4. A proposal to clarify the rule contained in section 1012(c)(4)(A) of the Tax Reform Act of 1986 to permit the continued exemption of pension business attributable to certain tax-exempt organizations by an insurance company, with a 5-year phase-out of the exemption.

5. A proposal to modify Code section 818(b) to permit an insurance company to realize an ordinary loss upon the sale of depreciable real property used in the company's trade or business.

6. A proposal to provide relief for small life insurance companies (defined as companies with under $500 million in assets) from the requirement of Code section 848 to capitalize policy acquisition costs by lowering the percentage of policy premiums (attributable to contracts other than annuity contracts and group life insurance contracts) required to be capitalized.

PASS-THROUGH ENTITIES

1. A proposal to modify the simplification proposals in H.R. 13 for large partnerships to provide that Code section 469(k) applies to newly-formed large non-publicly traded partnerships.

2. A proposal to allow members of the same family to be treated as a single shareholder for purposes of the Code's Subchapter S rules.

(MORE)

3. A proposal to permit the ownership of S corporation stock by a family trust under rules that would preclude such trust ownership from circumventing the current limitation of no more than 35 shareholders or causing income to be taxed at rates less than the maximum individual tax rates.

4. A proposal to modify current-law limitations on S corporations, including the limitations with respect to the number of shareholders, issuance of preferred stock, issuance of debt instruments, and fringe benefit rules.

5. A proposal to permit the interest income and rental expense with respect to safe harbor lease transactions of rural electric cooperatives to be netted and to allocate the difference between members and nonmembers in proportion to the business done with each.

COST RECOVERY

1. A proposal to reduce the depreciation period for semiconductor manufacturing equipment to 3 years.

2. A proposal to provide a 4-year recovery period for helicopters used in timber management and harvesting.

3. A proposal to allow the Merchant Marine Capital Construction Fund to be used to acquire or construct passenger vessels operated in the domestic trade.

4. A proposal to provide for the use of 200-percent declining balance depreciation for computers for alternative minimum tax purposes.

5. A proposal to extend the applicability of Code section 179 expensing to purchases of automobiles and light-duty trucks (possibly by amending or removing the Code section 280F cap for this purpose).

6. A proposal to provide a new class for leasehold improvements under the modified accelerated cost recovery system with respect to nonresidential real property.

EMPLOYEE BENEFITS

1. H.R. 736, a bill to clarify that veterans' benefits are not subject to taxation.

2. A proposal to exempt judicial pension plans from the nondiscrimination rules.

3. A proposal to provide that an annuity refund feature should not prevent an annuity owner from fully recovering basis under Code section 72(b).

4. H.R. 1807, a bill to treat employee stock ownership plans (ESOPs) as if they were charitable organizations for purposes of transferring stock of a closely-held corporation from a charitable remainder trust to an ESOP maintained by the closely-held corporation.

5. A proposal to provide relief for employers from the excise tax liability resulting from increased funding of certain unfunded liabilities in qualified pension plans.

6. A proposal to create a new safe harbor under which leased employees can be excluded from the pension plans of the service recipient organization.

7. A proposal to expand Code section 457 plans to provide benefits for volunteer fire and rescue personnel, including length-of-service awards, and to exclude such awards from Federal Insurance Contributions Act taxes.

8. H.R. 1981, a bill to permit football coaches to maintain Code section 401(k) plans through their organizations under the Code.

9. A proposal that, in order to guarantee family and medical leave, would provide for a pre-tax contribution account for employers to offer employees.

(MORE)

II. ITEMS RESERVED FOR FUTURE HEARING(S)

INDIVIDUAL

1. A proposal to prohibit employers from assessing a fee from employees who choose to receive the earned income tax credit (EITC) through the advance payment option.

2. A proposal to require employers to provide EITC information on the Wage and Tax Statement (Form W-2).

3. A proposal to require the Internal Revenue Service (IRS) to send information about the EITC advance payment option to all EITC recipients.

4. A proposal to modify section 1938 of the Energy Policy Act of 1992 to allow (subject to a facts and circumstances test) the deductibility of travel expenses incurred away from home by construction workers if the work project lasts longer than one year but not longer than 18 months; alternately, to provide that section 1938 of that Act does not apply to workers in the construction industry.

5. A proposal to allow a deduction for qualified adoption expenses, as provided in H.R. 930.

6. A proposal to exempt from income certain payments made to overseas employees of the Department of Defense to conform the tax rules for these employees to those for other U.S. Government personnel stationed overseas.

7. A proposal to permit taxpayers to claim a deduction or tax credit for interest paid on student loans.

8. A proposal to provide income tax deferral on gains from real property condemned by government under eminent domain, as provided in H.R. 142.

9. A proposal to allow a deduction for fees imposed by a State or local government or the District of Columbia for sewer and water services to the extent such fees exceed 1 percent (or 2 percent) of the taxpayer's adjusted gross income (AGI).

10. A proposal to extend certain tax benefits to soldiers serving in Somalia, as provided in H.R. 494.

11. A proposal to restore a charitable deduction for taxpayers who do not itemize deductions, as provided in H.R. 152.

12. A proposal to allow taxpayers receiving unemployment compensation to elect Federal income tax withholding at a flat 15-percent rate.

ESTATE AND GIFT

1. A proposal to clarify that where a spouse who is a nonparticipant in a qualified pension plan or individual retirement account predeceases the participant spouse, the estate tax marital deduction would apply.

2. A proposal to exclude from a gross estate the value of land subject to a permanent conservation easement.

3. A proposal to provide a special estate tax valuation rule for certain family-owned media businesses.

4. A proposal that, for purposes of the special use valuation rules under Code section 2032A, would increase the permissible aggregate reduction in fair market value from $750,000 to $1.5 million, as provided in H.R. 1411.

5. A proposal to provide relief from the retroactive application of gift tax regulations on disclaimers.

6. A proposal to permit cash rentals of Code section 2032A property by family members, effective for rentals, and decedents dying, after December 31, 1976.

(MORE)

7. A proposal to restore a limited marital deduction for estates of certain non-resident employees of international organizations, as provided in H.R. 770.

FOREIGN TAX PROVISIONS

1. H.R. 1401, a bill to modify the current subpart F rules and to encourage expansion of U.S. businesses into the European Community.

2. H.R. 1891, a bill to exempt from U.S. withholding tax specified kinds of dividends when distributed by a U.S. mutual fund to a foreign investor.

3. A proposal to clarify that the definition of export property for purposes of the foreign sales corporation rules includes the license of computer software to foreign distributors and customers with the right to reproduce.

4. A proposal to expand the foreign sales corporation rules to provide the same treatment for military sales as is currently provided for commercial sales.

5. A proposal to exempt interest on U.S. bank deposits from certain requirements of the United States-Netherlands Antilles Tax Treaty relationship.

6. A proposal to allow a controlled foreign corporation's (CFC's) pre-1987 shipping losses to be carried forward and applied against its post-1986 shipping income where substantially all of the CFC's pre-shipping income was included in its parent's gross income.

7. A proposal to reinstate pre-1987 provisions that allowed deferral of shipping income of U.S.-owned foreign shipping companies that is reinvested in shipping operations.

8. A proposal that, for purposes of Code section 956, would provide the same treatment for loans made by a CFC to unrelated noncorporate domestic persons as currently applies for loans to unrelated U.S. corporations.

9. A proposal to modify the consolidation rules under Code section 1504(d) to make the election available to all Canadian and Mexican corporations included in the affiliated group (as defined in Code section 1504(a) without regard to Code section 1504(b)(3)) whether or not they are prohibited by local law from operating as U.S. corporations. The election would be binding on all Canadian and Mexican members of the affiliated group and could not be revoked without the consent of the IRS.

10. A proposal to allow an affiliated group that includes a corporation predominantly engaged in financial services operations to treat the financial services corporation separately for purposes of the interest allocation rules.

11. A proposal to extend Code section 936 qualified possession source investment income treatment to investments in some or all of the Andean nations.

12. A proposal to permit corporations to allocate to U.S.-source income all deductions for tax payments made to States.

13. A proposal to expand the current-law exception from the definition of foreign personal holding company income for active business gains and losses from the sale of commodities by eliminating the requirement that "substantially all" of the CFC's business be as an active producer, processor, merchant, or handler of commodities.

14. A proposal to increase the threshold for reporting acquisitions of stock in foreign corporations from 5 percent to 10 percent of stock value.

15. A proposal to allow foreign corporations engaged in financing and credit services a passive foreign investment company exclusion comparable to that available to banking and insurance activities under current law.

(MORE)

16. A proposal to extend the period to which excess foreign tax credits may be carried forward from 5 to 15 years.

NATURAL RESOURCES

1. A proposal to reduce the capital gains tax with respect to timber sold for domestic processing, and to deny the benefits of certain export subsidies in the case of exports of unprocessed timber.

2. A proposal to modify the requirement of Code section 29 that taxpayers sell qualifying fuels to an unrelated person by making the fuels credit available in cases where taxpayers produce landfill gas, or synthetic gas from coal, and use the fuel on site for the generation of electricity for sale to unrelated persons.

3. A proposal to provide for a tax credit for the production of oil and gas from marginal properties.

4. A proposal to allow sellers of natural gas through a regulated public utility to qualify as independent producers, and to increase the refinery-run threshold which applies for purposes of determining whether the taxpayer is a refiner.

5. H.R. 2026, a bill to amend the Code to encourage energy efficiency and the production and use of renewable energy.

6. A proposal to allow geothermal, solar, and wind energy producers to apply energy tax credits and production credits against alternative minimum tax liability.

7. H.R. 960, a bill to ease the passive activity loss restrictions for closely-held timber activities.

8. A proposal to provide for the retroactive application of provisions of H.R. 776, the Energy Policy Act of 1992, relating to exclusion from income of energy conservation subsidies provided by public utilities.

HOUSING

1. A proposal to provide certain "tenant protection" amendments with respect to the low-income housing tax credit (LIHC) (e.g., limitations on when an individual can be denied tenancy at a LIHC project).

2. A proposal to allow certain community service facilities to be included in eligible basis for purposes of the LIHC.

3. A proposal to allow LIHC projects developed with credits issued before 1989 to use relaxed income compliance provisions for tenants where there is a 2 to 1 ratio rent skew between market and low-income rents.

4. A proposal that, for purposes of the LIHC carryforward rule, would treat credits carried forward from previous years as used before current-year credits.

5. A proposal to allow use of the 70-percent present value LIHC in conjunction with tax-exempt bonds.

6. A proposal to allow States to designate "difficult to develop" areas for purposes of the LIHC.

7. A proposal to amend LIHC rules to allow a State that has retained a de minimis amount of credits to access the national pool.

8. A proposal to provide that, notwithstanding other laws or regulations, a LIHC project may be eligible for the historic rehabilitation tax credit even if interior walls are not preserved.

9. A proposal to provide that the current-law $200,000 income limit with respect to the historic rehabilitation tax credit would not apply to such credits used in LIHC projects (and, possibly, other projects).

10. A proposal to extend the LIHC to residential units the tenants of which have income above 60 percent (but less than 100 percent) of

(MORE)

area median income if, for each such unit, there is another LIHC unit in the project for which the tenant's income falls below the 40-percent threshold.

11. A proposal to allow a housing unit occupied by a single parent and his or her child to qualify for the LIHC if the parent and child are both full-time students.

12. A proposal to provide the Treasury with authority to waive penalties for de minimis errors in the application of the LIHC tenant occupancy requirements.

13. A proposal to provide the Treasury with authority to waive the annual requirement that tenant income be recertified with respect to buildings occupied entirely by low-income tenants.

14. A proposal to allow the LIHC to be used by the buyer or the seller in the year in which a LIHC project is disposed.

15. A proposal to clarify that the allocation of the LIHC between the buyer and seller of credit property may be based on either the exact number of days or the mid-month convention.

16. A proposal to clarify Treasury's authority to waive certain requirements regarding receipt of third-party verifications in 100-percent low-income properties.

17. A proposal to provide relief for co-ops from tax on interest on reasonable reserves and income from laundries and parking for the co-op operators, and to provide relief for commercial rentals for limited equity housing co-ops (and Mitchell-Lama co-ops).

18. A proposal that, for buildings in certain distressed central business districts, would increase the amount of the historic rehabilitation tax credit and would repeal the AGI phaseout of that credit.

19. A proposal to modify the historic rehabilitation tax credit, as provided in H.R. 1406.

20. A proposal that, for purposes of the historic rehabilitation tax credit, would increase the AGI phaseout amount and the current-law $25,000 deduction equivalent amount.

21. A proposal to provide that the treatment of tenant-stockholders in cooperative housing also shall apply to stockholders of corporations that only own the land on which the residences are located.

22. A proposal that would provide for 15-year depreciation and an exemption from the passive activity loss rules for new investors in order to encourage the rehabilitation of certain privately-owned low-income housing.

TAX-EXEMPT BONDS

1. A proposal to provide that governmentally-owned spaceports would be eligible for tax-exempt financing to the same extent as airports.

2. A proposal to expand the veterans' mortgage bond program to include veterans of Desert Storm and Grenada.

3. A proposal to expand the veterans' mortgage bond program to remove the current-law exclusion of veterans who served after 1976 or who left service more than 30 years ago and to impose an overall volume cap of $300 million on existing programs, as provided in H.R. 1289.

4. A proposal to allow mortgage revenue bond (MRB) proceeds to be used for purchases of new two-family houses located in certain distressed areas.

5. A proposal to modify the MRB program as it relates to cooperative housing (for example, by loosening the application of the

(MORE)

current-law acquisition cost limits; allowing interim rental use while units are being sold; and changing how retail and parking elements in these properties are allocated).

6. A proposal to increase the current-law limit on MRB-financed home improvements loans from $15,000 to $25,000.

7. A proposal to create an exception to the private-loan bond rules for certain housing bonds.

8. A proposal to modify the bank deductibility limit as it applies to bonds issued for Code section 501(c)(3) borrowers by applying a $5 million limit at the Code section 501(c)(3) borrower level (instead of the current-law issuer level limit for these bonds).

9. A proposal to increase the current-law bank deductibility limit from $10 million to $20 million.

10. A proposal to allow the issuance of tax-exempt bonds for volunteer fire departments to purchase ambulances and other emergency response equipment, as provided in H.R. 219.

11. A proposal to extend the date by which tax-exempt bonds related to a certain federally-funded construction project must be issued and to extend the date by which that project is required to be placed in service to qualify for treatment under the cost-recovery rules in effect prior to the enactment of the Tax Reform Act of 1986.

12. A proposal to redirect use of tax-exempt bonds which have been issued for a new science facility at Stanford to "earthquake-proof" existing campus facilities.

13. A proposal to modify the rules governing tax-exempt bonds to conform generally the treatment of bonds issued for Code section 501(c)(3) organizations to that provided for bonds issued to finance direct State or local governmental activities.

14. A proposal to codify the definition of basic research and to allow bonds issued to build research facilities owned by a governmental agency or a Code section 501(c)(3) entity, and used in research as part of a cooperative arrangement with a nongovernmental and/or non-exempt entity, to be exempt from the private activity bond rules.

15. A proposal to extend the six-month exception from rebate to certain bonds the proceeds of which included a debt service reserve and which were issued after the Tax Reform Act of 1986 and before the Budget Reconciliation Act of 1989.

16. A proposal to increase the percentage of private benefit permitted for governmental bonds.

17. A proposal to treat State bond proceeds as spent when they are deposited in a revolving fund established for a purpose created by Federal law in an amount not greater than the minimum amount required under that law.

18. A proposal to clarify the description of certain projects in the City of Kenosha, Wisconsin, that was contained in the Tax Reform Act of 1986, in order to allow that city to issue qualified tax-exempt bonds for redevelopment.

19. A proposal to repeal the $15 million limitation on the amount of a tax-exempt bond issue which may be used by an output facility, as provided in H.R. 1938.

20. A proposal to reallocate the unused portion of State private activity bond volume caps to States which have used their entire cap for the year.

21. A proposal that, for purposes of the qualified small-issue bond program, would extend the one-year "issue period" to 90 days after the program is extended if the issue period expired after June 30, 1992, and before the program's extension.

(MORE)

COMPLIANCE ISSUES

1. A proposal to clarify that the statutory prohibition on separately stated charges under Code section 6045(e) does not prohibit title agents and others from recovering the costs of reporting certain information to the IRS.

2. A proposal to provide for the direct deposit of tax refunds into taxpayers' bank accounts.

MISCELLANEOUS ISSUES

1. H.R. 1325, the Indian Employment and Investment Act of 1993, a bill to provide tax credits for Indian investment and employment.

2. A proposal to grant Alaska Native Corporations standing to litigate the validity of their net operating losses under certain circumstances.

3. A proposal to provide a tax credit for qualifying contributions to certain research consortia.

4. A proposal to provide an enhanced deduction for charitable contributions of computer equipment to arts institutions.

5. A proposal to treat private foundations like educational organizations and pension funds for purposes of the unrelated business income rules governing debt-financed property.

6. A proposal to exclude closely-held equipment leasing from the definition of rental activity for purposes of the passive activity loss rules.

7. A proposal to exempt from the at-risk rules certain nonrecourse loans made by federally-insured financial institutions to finance the sale of real property foreclosed upon by such institutions.

8. A proposal to repeal Code section 58(a) (relating to the denial of losses from tax shelter farm activities for purposes of the alternative minimum tax).

9. Two proposals to modify the harbor maintenance tax: (i) suspending collection of the tax when the trust fund balance reaches a certain threshold amount, and (ii) using tax revenues to support nautical charting and marine navigational safety programs and other activities of the National Oceanic and Atmospheric Administration.

10. A proposal to phase out the special occupational tax on liquor dealers and merchants.

11. H.R. 1929, a bill to exempt trucks that handle and mix explosives from the excise tax on heavy trucks.

12. A proposal to clarify that unexpended State funds do not count toward the $70 million cap on transfers of fuel tax revenues to the Boat Safety Account of the Aquatic Resources Trust Fund.

13. A proposal to consolidate and impose Federal excise taxes on aviation gasoline at the refinery level.

14. A proposal to extend the "in service" date for projects affected by section 204(a)(1)(E) of the Tax Reform Act of 1986.

15. A proposal to repeal or establish a safe harbor regarding the accumulated earnings tax for widely-held corporations.

16. A proposal to permit the use of whey, tomatoes, and other agricultural products in making wine spirits.

17. A proposal to modify the definition of start-up companies under the research and development tax credit (Code section 41(c)(3)(B)(i)).

18. A proposal to authorize the deposit of 1 cent of the tax on diesel fuel used by railroads into an Intercity Rail Passenger Capital Improvement Trust Fund through 1998.

(MORE)

DETAILS FOR SUBMISSION OF REQUESTS TO BE HEARD:

Individuals and organizations interested in presenting oral testimony before the Committee on any issue specifically described herein must submit their requests to be heard by telephone to Harriett Lawler, Diane Kirkland, or Karen Ponzurick [(202) 225-1721] no later than Tuesday, June 8, 1993, to be followed by a formal written request to Janice Mays, Chief Counsel and Staff Director, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. The Subcommittee staff will notify by telephone those scheduled to appear as soon as possible after the filing deadline. Any questions concerning a scheduled appearance should be directed to the Subcommittee [(202) 225-9710].

Persons and organizations having a common position are urged to make every effort to designate one spokesperson to represent them in order for the Subcommittee to hear as many points of view as possible. Time for oral presentations will be strictly limited with the understanding that a more detailed statement may be included in the printed record of the hearing (see formatting requirements below). This process will afford more time for Members to question witnesses. In addition, witnesses may be grouped as panelists with strict time limitations for each panelist.

In order to assure the most productive use of the limited amount of time available to question hearing witnesses, all witnesses scheduled to appear before the Subcommittee are required to submit 200 copies of their prepared statements to the Subcommittee office, room 1105 Longworth House Office Building, at least 24 hours in advance of their scheduled appearance. Failure to comply with this requirement may result in the witness being denied the opportunity to testify in person.

WRITTEN STATEMENTS IN LIEU OF PERSONAL APPEARANCE:

Persons submitting written statements for the printed record of the hearing should submit at least six (6) copies by the close of business on the last day of hearings to Janice Mays, Chief Counsel and Staff Director, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. If those filing written statements for the record of the printed hearing wish to have their statements distributed to the press and the interested public, they may provide 100 additional copies for this purpose to the Subcommittee office, room 1105 Longworth House Office Building, before the hearing begins.

FORMATTING REQUIREMENTS:

Each statement presented for printing to the Committee by a witness, any written statement or exhibit submitted for the printed record or any written comments in response to a request for written comments must conform to the guidelines listed below. Any statement or exhibit not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All statements and any accompanying exhibits for printing must be typed in single space on legal-size paper and may not exceed a total of 10 pages.

2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.

3. Statements must contain the name and capacity in which the witness will appear or, for written comments, the name and capacity of the person submitting the statement, as well as any clients or persons, or any organization for whom the witness appears or for whom the statement is submitted.

4. A supplemental sheet must accompany each statement listing the name, full address, a telephone number where the witness or the designated representative may be reached and a topical outline or summary of the comments and recommendations in the full statement. This supplemental sheet will not be included in the printed record.

The above restrictions and limitations apply only to material being submitted for printing. Statements and exhibits or supplementary material submitted solely for distribution to the Members, the press and the public during the course of a public hearing may be submitted in other forms.

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FOR IMMEDIATE RELEASE
FRIDAY, JUNE 11, 1993

PRESS RELEASE #6
SUBCOMMITTEE ON SELECT REVENUE MEASURES
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
1102 LONGWORTH HOUSE OFFICE BUILDING
WASHINGTON, D.C. 20515
TELEPHONE: (202) 225-1721

THE HONORABLE CHARLES B. RANGEL (D., N.Y.), CHAIRMAN, SUBCOMMITTEE ON SELECT REVENUE MEASURES, COMMITTEE ON WAYS AND MEANS, U.S. HOUSE OF REPRESENTATIVES, ANNOUNCES ADDITIONAL HEARINGS ON MISCELLANEOUS REVENUE ISSUES

The Honorable Charles B. Rangel (D., N.Y.), Chairman, Subcommittee on Select Revenue Measures, Committee on Ways and Means, U.S. House of Representatives, announced today that the Subcommittee will hold additional public hearings on miscellaneous revenue issues. These hearings will be held on Tuesday, June 22, 1993, in the main Committee hearing room, 1100 Longworth House Office Building, and on Thursday, June 24, 1993, in room B-318 Rayburn House Office Building. On both dates, the hearings will begin at 10:00 a.m. Additional hearings will be announced in a subsequent press release.

BACKGROUND

In press release #4, dated June 2, 1993, the Subcommittee described a number of revenue items on which hearings would be held on Thursday, June 17, 1993, and on additional hearing days. The Subcommittee now is announcing additional hearing days for those items described, as well as for several additional miscellaneous items, described below. The Subcommittee also wishes to clarify the descriptions of certain items described in press release #4.

I. ITEMS SCHEDULED FOR JUNE 22 HEARING

On June 22, 1993, the Subcommittee will receive testimony from representatives of the Department of the Treasury on all the items described in press release #4 (and the additional items described below). In addition, on June 22, the Subcommittee will receive public testimony on issues described in press release #4 that were listed under the heading of "Miscellaneous Issues." Further, the issues listed as relating to pass-through entities will be addressed on June 22, rather than on June 17.

II. ITEMS SCHEDULED FOR JUNE 24 HEARING

The hearing to be held on June 24 is limited to proposals described in press release #4 relating to foreign tax provisions, natural resources, and estate and gift issues.

III. ITEMS RESERVED FOR FUTURE HEARING

The proposals described in press release #4 relating to housing, tax-exempt bonds, individual, and compliance issues will be addressed at a hearing which will be announced in a subsequent press release. That hearing also will address the following additional proposals:

1. A proposal to provide for the use of 200-percent declining balance depreciation for automobiles for alternative minimum tax purposes.

2. A proposal to amend Internal Revenue Code (Code) section 142(c) to allow exempt facility bonds to be issued for certain transportation facilities (including trackage and rail facilities) used for the transport of cargo or passengers mainly to or from airports, docks, or wharves, regardless of whether the facilities meet the governmental ownership requirement of Code section 142(b)(1).

3. H.R. 2340, a bill to amend the Code to allow a credit and tax-exempt financing for the acquisition, cleanup, and redevelopment of certain contaminated former industrial sites.

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4. A proposal to provide that, in the case of nonbank lending institutions with a high volume of low balance, homogeneous loans, a loan would be presumed worthless no later than the time it would be determined worthless under the regulatory criteria applicable to regulated depository institutions, such as banks and thrift institutions, so long as the loan has been written off for financial accounting purposes.

5. A proposal to eliminate the rule treating distributors of bakery products as statutory employees for purposes of Social Security payroll taxation and coverage, and to treat such persons as independent contractors.

6. A proposal to provide that, for purposes of the Social Security tax rules for concurrent employment by two or more employers, certain State universities and agency accounts of such universities would be deemed related corporations.

7. H.R. 931, a bill to require the Treasury to issue to the Social Security trust funds certificates evidencing U.S. obligations held by the funds and stating the Federal Government's obligation to repay principal and interest.

8. A proposal to exempt services performed for elementary or secondary schools which operate primarily for religious purposes, but do not meet the current-law "affiliation test," from tax under the Federal Unemployment Tax Act.

IV. CLARIFICATION OF CERTAIN ITEMS DESCRIBED IN PRESS RELEASE #4

Press release #4 invited testimony on H.R. 2026, a bill to amend the Tax Code to encourage energy efficiency and the production and use of renewable energy. One of the provisions of H.R. 2026, relating to the tax treatment of conservation expenditures by electric and gas utilities, has been separately introduced as H.R. 784, which is also within the scope of the hearing.

Press release #4 also invited testimony on a proposal to provide a new recovery period for helicopters used in timber management and harvesting. The Subcommittee wishes to clarify that the proposal is to depreciate such helicopters over 3 years for regular tax purposes and over 4 years for alternative minimum tax purposes.

Finally, press release #4 invited testimony on a bill to clarify that veterans' benefits are not subject to taxation. In fact, two proposals clarifying the taxation of these benefits are the subject of the Subcommittee hearings: one proposal is contained in H.R. 736, and another proposal is contained in H.R. 786.

DETAILS FOR SUBMISSION OF REQUESTS TO BE HEARD:

Individuals and organizations interested in presenting oral testimony before the Committee on any of the eight additional miscellaneous proposals specifically described herein which are reserved for the hearing to be announced in the future must submit their requests to be heard by telephone to Harriett Lawler, Diane Kirkland, or Karen Ponzurick [(202) 225-1721] no later than Wednesday, June 16, 1993, to be followed by a formal written request to Janice Mays, Chief Counsel and Staff Director, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. The Subcommittee staff will notify by telephone those scheduled to appear as soon as possible after the filing deadline. Any questions concerning a scheduled appearance should be directed to the Subcommittee [(202) 225-9710].

Persons and organizations having a common position are urged to make every effort to designate one spokesperson to represent them in order for the Subcommittee to hear as many points of view as possible. Time for oral presentations will be strictly limited with the understanding that a more detailed statement may be included in the printed record of the hearing (see formatting requirements below). This process will afford more time for Members to question witnesses. In addition, witnesses may be grouped as panelists with strict time limitations for each panelist.

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In order to assure the most productive use of the limited amount of time available to question hearing witnesses, all witnesses scheduled to appear before the Subcommittee are required to submit 200 copies of their prepared statements to the Subcommittee office, room 1105 Longworth House Office Building, at least 24 hours in advance of their scheduled appearance. Failure to comply with this requirement may result in the witness being denied the opportunity to testify in person.

WRITTEN STATEMENTS IN LIEU OF PERSONAL APPEARANCE:

Persons submitting written statements for the printed record of the hearing should submit at least six (6) copies by the close of business on the last day of hearings to Janice Mays, Chief Counsel and Staff Director, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. If those filing written statements for the record of the printed hearing wish to have their statements distributed to the press and the interested public, they may provide 100 additional copies for this purpose to the Subcommittee office, room 1105 Longworth House Office Building, before the hearing begins.

FORMATTING REQUIREMENTS:

Each statement presented for printing to the Committee by a witness, any written statement or exhibit submitted for the printed record or any written comments in response to a request for written comments must conform to the guidelines listed below. Any statement or exhibit not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

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FOR IMMEDIATE RELEASE
THURSDAY, JULY 1, 1993

PRESS RELEASE #7
SUBCOMMITTEE ON SELECT REVENUE MEASURES
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
1102 LONGWORTH HOUSE OFFICE BUILDING
WASHINGTON, D.C. 20515
TELEPHONE: (202) 225-1721

THE HONORABLE CHARLES B. RANGEL (D., N.Y.), CHAIRMAN, SUBCOMMITTEE ON SELECT REVENUE MEASURES, COMMITTEE ON WAYS AND MEANS, U.S. HOUSE OF REPRESENTATIVES, ANNOUNCES LAST DAY OF HEARINGS ON MISCELLANEOUS REVENUE ISSUES

The Honorable Charles B. Rangel (D., N.Y.), Chairman, Subcommittee on Select Revenue Measures, Committee on Ways and Means, U.S. House of Representatives, announced today that the Subcommittee will hold a final day of public hearings on miscellaneous revenue issues. The hearing will be held on Tuesday, July 13, 1993, beginning at 11:00 a.m., in room B-318 Rayburn House Office Building.

The Subcommittee previously held hearings on miscellaneous revenue issues on June 17, June 22 and June 24, 1993. (See press release #4, dated June 2, and press release #6, dated June 11, 1993, for details.)

SCOPE OF HEARING

The Subcommittee will receive testimony on the proposals specifically described in press release #4 relating to housing, tax-exempt bonds, individual, and compliance issues. In addition, testimony will be received on the eight items specifically described in press release #6, and on the following new proposals which have been referred to the Subcommittee for hearings:

1. A proposal to extend the special deduction available under current law to insurers of State and local obligations to insurers of certain debt that is not tax-exempt.

2. A proposal to reduce the amount of policy acquisition costs that are required to be amortized by life insurance companies selling payroll-marketed noncancellable or guaranteed-renewable individual accident and health policies by applying the same rate applicable to group life insurance.

3. A proposal to increase the eligible income level from $16,000 to $36,000 for employees of the performing arts for purposes of the limitation on the deduction for unreimbursed business expenses.

4. A proposal to permit a deduction for a certain percentage of total contributions made to an employee stock option plan which is based on the overall capital investment, or alternatively, total payroll of the sponsoring company.

5. A proposal to provide transition relief to nonprofit student loan funding corporations by permitting such entities to elect to transfer their assets and liabilities to a for-profit taxable subsidiary without causing the interest on their outstanding tax-exempt debt to become taxable and without triggering certain private foundation restrictions.

DETAILS FOR SUBMISSION DETAILS FOR SUBMISSION OF REQUESTS TO BE HEARD:

Individuals and organizations interested in presenting oral testimony before the Subcommittee on any of the new proposals specifically described herein must submit their requests to be heard by telephone to Harriett Lawler, Diane Kirkland, or Karen Ponzurick [(202) 225-1721] no later than noon, Thursday, July 8, 1993, to be followed by a formal written request to Janice Mays, Chief Counsel and Staff Director, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. The Subcommittee staff will notify by telephone those scheduled to appear as soon as possible after the filing deadline. Any questions concerning a scheduled appearance should be directed to the Subcommittee [(202) 225-9710].

(MORE)

Persons and organizations having a common position are urged to make every effort to designate one spokesperson to represent them in order for the Subcommittee to hear as many points of view as possible. Time for oral presentations will be strictly limited with the understanding that a more detailed statement may be included in the printed record of the hearing (see formatting requirements below). This process will afford more time for Members to question witnesses. In addition, witnesses may be grouped as panelists with strict time limitations for each panelist.

In order to assure the most productive use of the limited amount of time available to question hearing witnesses, all witnesses scheduled to appear before the Subcommittee are required to submit 200 copies of their prepared statements to the Subcommittee office, room 1105 Longworth House Office Building, at least 24 hours in advance of their scheduled appearance. Failure to comply with this requirement may result in the witness being denied the opportunity to testify in person.

WRITTEN STATEMENTS IN LIEU OF PERSONAL APPEARANCE:

Persons submitting written statements for the printed record of the hearing should submit at least six (6) copies by the close of business on Tuesday, July 20, 1993, to Janice Mays, Chief Counsel and Staff Director, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. If those filing written statements for the record of the printed hearing wish to have their statements distributed to the press and the interested public, they may provide 100 additional copies for this purpose to the Subcommittee office, room 1105 Longworth House Office Building, before the hearing begins.

FORMATTING REQUIREMENTS:

Each statement presented for printing to the Committee by a witness, any written statement or exhibit submitted for the printed record or any written comments in response to a request for written comments must conform to the guidelines listed below. Any statement or exhibit not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

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2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.

3. Statements must contain the name and capacity in which the witness will appear or, for written comments, the name and capacity of the person submitting the statement, as well as any clients or persons, or any organization for whom the witness appears or for whom the statement is submitted.

4. A supplemental sheet must accompany each statement listing the name, full address, a telephone number where the witness or the designated representative may be reached and a topical outline or summary of the comments and recommendations in the full statement. This supplemental sheet will not be included in the printed record.

The above restrictions and limitations apply only to material being submitted for printing. Statements and exhibits or supplementary material submitted solely for distribution to the Members, the press and the public during the course of a public hearing may be submitted in other forms.

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FOR IMMEDIATE RELEASE
FRIDAY, JULY 9, 1993

PRESS RELEASE #8
SUBCOMMITTEE ON SELECT REVENUE MEASURES
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
1102 LONGWORTH HOUSE OFFICE BUILDING
WASHINGTON, D.C. 20515
TELEPHONE: (202) 225-1721

THE HONORABLE CHARLES B. RANGEL (D., N.Y.), CHAIRMAN, SUBCOMMITTEE ON SELECT REVENUE MEASURES, COMMITTEE ON WAYS AND MEANS, U.S. HOUSE OF REPRESENTATIVES, ANNOUNCES THE ADDITION OF ANOTHER DAY FOR ITS FINAL HEARING ON CERTAIN MISCELLANEOUS REVENUE ISSUES

The Honorable Charles B. Rangel (D., N.Y.), Chairman, Subcommittee on Select Revenue Measures, Committee on Ways and Means, U.S. House of Representatives, today announced that the Subcommittee will add another day of hearings for its final hearing with respect to certain previously-announced miscellaneous revenue proposals, to be announced at a later time.

In press release #7, dated Thursday, July 1, 1993, the Subcommittee announced that its final day in the series of hearings would be Tuesday, July 13, 1993. The additional day of hearings to be announced will cover those items specifically described as new proposals in press release #6 (except item #3, part III), dated Friday, June 11, 1993, and in press release #7. In addition, testimony on item #4 under miscellaneous issues in press release #4, dated Friday, June 2, 1993, will be received at the additional hearing. Consequently, the Subcommittee will receive testimony on Tuesday, July 13, 1993, only on the proposals specifically described in press release #4 relating to housing, tax-exempt bonds, individual, and compliance issues, and press release #6, item #3, H.R. 2340.

In response to significant interest on the part of the public in testifying on these issues, the additional hearing date will be scheduled to accommodate those members of the public who, in accordance with the press releases listed above, already have requested to be heard and have been contacted by the Subcommittee. Other interested members of the public are invited to submit written statements for the record of these proceedings in accordance with the rules set forth in press release #7. Details for submission of statements for the record for issues at the additional hearing will be announced at a later time.

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FOR IMMEDIATE RELEASE
TUESDAY, AUGUST 17, 1993

PRESS RELEASE #9
SUBCOMMITTEE ON SELECT REVENUE MEASURES
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
1102 LONGWORTH HOUSE OFFICE BUILDING
WASHINGTON, D.C. 20515
TELEPHONE: (202) 225-1721

THE HONORABLE CHARLES B. RANGEL (D., N.Y.), CHAIRMAN, SUBCOMMITTEE ON SELECT REVENUE MEASURES, COMMITTEE ON WAYS AND MEANS, U.S. HOUSE OF REPRESENTATIVES, ANNOUNCES FURTHER HEARINGS ON MISCELLANEOUS REVENUE ISSUES

The Honorable Charles B. Rangel (D., N.Y.), Chairman, Subcommittee on Select Revenue Measures, Committee on Ways and Means, U.S. House of Representatives, announced today two additional days of hearings on miscellaneous revenue issues. The hearings will be held on Wednesday, September 8, 1993, in the main Committee hearing room, 1100 Longworth House Office Building, and on Tuesday, September 14, 1993, in room B-318, Rayburn House Office Building. The hearings on both days will begin at 10:00 a.m.

BACKGROUND

The Subcommittee has issued press releases and held a series of public hearings relating to miscellaneous revenue issues submitted by Members of the Committee. On September 8, the Subcommittee will receive testimony on those proposals described in press release #8, dated July 9, 1993, as well as on one additional miscellaneous proposal which is described below.

As part of this process, Members also have suggested various revenue-raising provisions to ensure that these miscellaneous issues could be legislated on a revenue-neutral basis. On September 8, the Subcommittee also will receive testimony on the revenue-raising proposals specifically described below; and on September 14, the Subcommittee will receive testimony on revenue-raising proposals that will be described in a subsequent press release. The proposals that are the subject of these hearings consist of proposals suggested by Members.

In addition to the revenue-raising proposals addressed at the hearings on September 8 and 14, any additional revenue-raising proposals subsequently brought to the Committee's attention by any Member of the Committee could be used as a potential revenue offset for a miscellaneous revenue provision.

Because of the Committee's anticipated busy Fall schedule and the resulting time restrictions on the duration of these hearings, the Subcommittee strongly encourages those interested in expressing their views to submit written testimony rather than to request to testify orally. Further, all persons wishing to testify on similar issues are strongly encouraged to designate one spokesperson to represent their views.

I. ADDITIONAL MISCELLANEOUS REVENUE PROPOSAL

1. A proposal to permit an employer who sponsors an employee stock option plan (ESOP) to modify the ESOP to restrict in-service distributions of employer stock contributed to the ESOP prior to the date of legislation, if such stock will be rolled over by the participant to another qualified plan.

II. REVENUE-RAISING PROPOSALS

ALTERNATIVE MINIMUM TAX

1. A proposal to lengthen the alternative minimum tax recovery period for assets used in the production of cigarettes, cigars, smoking and chewing tobacco, snuff, and other tobacco products.

(MORE)

2. A proposal to lengthen by one to three years the recovery period for coal mining equipment under the alternative minimum tax.

3. A proposal to lengthen from 10 years to 20 years the amortization period for mining exploration and development costs incurred with respect to coal mining, for purposes of the alternative minimum tax under Internal Revenue Code (Code) section 56(a)(2).

ACCOUNTING

1. A proposal to apply the special rules applicable to high-yield discount obligations under Code section 163(i) to any obligation that has a maturity of more than four (rather than five) years.

2. A proposal to require organizational expenses to be amortized over 14 years (or some other period of years).

3. A proposal to require that a portion of advertising expenses be capitalized and amortized over a period of years.

FINANCIAL INSTITUTIONS

1. A proposal to require (a) thrift institutions to take points on single family mortgages into income when received, or (b) all mortgage originators to take such points into income when received.

2. A proposal to require thrift institutions to take net operating loss carryovers into account for purposes of calculating bad debt reserve deductions under the percentage of taxable income method.

COST RECOVERY

1. A proposal to provide a 25-year recovery period for certain water utility property, as described in H.R. 846.

2. A proposal to extend the recovery period applicable to certain assets used in printing and publishing to 10 years.

PASS-THROUGH ENTITIES

1. A proposal to clarify the rules relating to the timing of the flow-through of income to estates that own interests in partnerships or S corporations.

2. A proposal to repeal the Code section 1374(d)(2)(A)(ii) taxable income limitation on the recognition of built-in gain of S corporations.

INDIVIDUAL INCOME TAX

1. A proposal to deny certain deductions for travel expenses paid or incurred while away from home in connection with holding or managing real property unless holding or managing real property is the taxpayer's principal business activity.

2. A proposal to freeze the standard mileage rate used to determine deductible automobile expenses incurred for the business use of such vehicles at the 1993 level for the 1994 taxable year and, thereafter, to round down the amount computed by the Internal Revenue Service to the nearest whole cent.

3. A proposal to limit the business mileage deduction for trips beginning at the taxpayer's home to mileage in excess of 10 miles.

4. A proposal to require taxpayers to include in income the rental income received with respect to the rental of a residence without regard to the period of the rental (repeal or modify Code section 280A(g)).

(MORE)

5. A proposal to limit the deduction for wagering losses to 80 percent of the amount otherwise deductible.

6. A proposal to deny a business deduction for travel expenses in excess of the amount of coach fare if coach passage is available for the trip.

7. A proposal to increase the threshold for the deduction of casualty losses from $100 to $500.

NATURAL RESOURCES

1. A proposal to impose a severance tax (possibly at a 12-percent rate) on hard rock minerals, such as gold, silver, and copper.

2. A proposal to increase the tariff on imported crude oil by 15-cents-per-barrel and refined petroleum products by 1-cent-per-gallon.

DETAILS FOR SUBMISSION OF REQUESTS TO BE HEARD:

Individuals and organizations interested in presenting oral testimony before the Committee on any of the proposals specifically described herein must submit their requests to be heard by telephone to Harriett Lawler, Diane Kirkland, or Karen Ponzurick [(202) 225-1721] no later than Wednesday, August 25, 1993, to be followed by a formal written request to Janice Mays, Chief Counsel and Staff Director, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. The Subcommittee staff will notify by telephone those scheduled to appear as soon as possible after the filing deadline. Any questions concerning a scheduled appearance should be directed to the Subcommittee [(202) 225-9710].

Persons and organizations having a common position are urged to make every effort to designate one spokesperson to represent them in order for the Subcommittee to hear as many points of view as possible. Time for oral presentations will be strictly limited with the understanding that a more detailed statement may be included in the printed record of the hearing. (See formatting requirements below.) This process will afford more time for Members to question witnesses. In addition, witnesses may be grouped as panelists with strict time limitations for each panelist.

In order to assure the most productive use of the limited amount of time available to question hearing witnesses, all witnesses scheduled to appear before the Subcommittee are required to submit 200 copies of their prepared statements to the Subcommittee office, room 1105 Longworth House Office Building, at least 24 hours in advance of their scheduled appearance. Failure to comply with this requirement may result in the witness being denied the opportunity to testify in person.

WRITTEN STATEMENTS IN LIEU OF PERSONAL APPEARANCE:

Persons submitting written statements for the printed record of the hearing should submit at least six (6) copies by the close of business on Wednesday, September 15, 1993, to Janice Mays, Chief Counsel and Staff Director, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. If those filing written statements for the record of the printed hearing wish to have their statements distributed to the press and the interested public, they may provide 100 additional copies for this purpose to the Subcommittee office, room 1105 Longworth House Office Building, before the hearing begins.

FORMATTING REQUIREMENTS:

Each statement presented for printing to the Committee by a witness, any written statement or exhibit submitted for the printed record or any written comments in response to a request for written comments must conform to the guidelines listed below. Any statement or exhibit not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All statements and any accompanying exhibits for printing must be typed in single space on legal-size paper and may not exceed a total of 10 pages.

(MORE)

2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.

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4. A supplemental sheet must accompany each statement listing the name, full address, a telephone number where the witness or the designated representative may be reached and a topical outline or summary of the comments and recommendations in the full statement. This supplemental sheet will not be included in the printed record.

The above restrictions and limitations apply only to material being submitted for printing. Statements and exhibits or supplementary material submitted solely for distribution to the Members, the press and the public during the course of a public hearing may be submitted in other forms.

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FOR IMMEDIATE RELEASE
WEDNESDAY, AUGUST 18, 1993

PRESS RELEASE #10
SUBCOMMITTEE ON SELECT REVENUE MEASURES
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
1102 LONGWORTH HOUSE OFFICE BLDG.
WASHINGTON, D.C. 20515
TELEPHONE: (202) 225-1721

THE HONORABLE CHARLES B. RANGEL (D., N.Y.), CHAIRMAN, SUBCOMMITTEE ON SELECT REVENUE MEASURES, COMMITTEE ON WAYS AND MEANS, U.S. HOUSE OF REPRESENTATIVES, ANNOUNCES MISCELLANEOUS REVENUE-RAISING PROPOSALS THAT WILL BE THE SUBJECT OF THE SEPTEMBER 14TH HEARING

The Honorable Charles B. Rangel (D., N.Y.), Chairman, Subcommittee on Select Revenue Measures, Committee on Ways and Means, U.S. House of Representatives, announced today that the following miscellaneous revenue-raising proposals suggested by Members will be the subject of the hearing to be held on Tuesday, September 14, 1993. (See press release #9, dated August 17, 1993, for details regarding the miscellaneous revenue issue process and the announcement of the September 14 hearing.)

FOREIGN TAX PROVISIONS

1. A proposal based upon a provision in H.R. 5270, as introduced in the 102d Congress, to modify the method by which income from the sale of inventory property is sourced.

2. A proposal to increase from four percent to eight percent the tax imposed under Internal Revenue Code (Code) section 887 on gross transportation income of nonresident aliens and foreign corporations.

3. A bill (H.R. 220) to reinstate the tax on interest received by foreigners on certain portfolio investments.

4. A proposal to change the foreign tax credit to a deduction.

5. A proposal from H.R. 5270, as introduced in the 102d Congress, to increase from one percent to four percent the excise tax on certain premiums paid to foreign persons for reinsurance covering casualty insurance and indemnity bonds.

EXCISE TAXES

1. A proposal to increase the wagering excise tax on State authorized wagers in Code section 4401 from 0.25 percent to one percent.

2. A proposal to impose a five-percent excise tax on purchases by foreign corporations that fail to provide the Internal Revenue Service with tax information.

3. A proposal to increase the tax on prohibited transactions under Code section 4975 to 10 percent.

4. A proposal to increase the excise tax on domestically produced cigarettes with less than 80-percent domestic tobacco leaf content.

5. A proposal to increase tobacco excise taxes by 0.6 cents.

6. A proposal to extend the three-percent communications excise tax to cable television services.

7. A proposal to repeal the exemption from the communications excise tax for communications services furnished to news services.

(MORE)

8. A proposal to impose an excise tax on carbon dioxide (CO_2) sales by ethanol producers at a rate which would offset the current ethanol tax subsidies.

9. A proposal to increase the heavy truck chassis tax from 12 percent to 12.1 percent.

10. Proposals to add the following to the list of taxable ozone-depleting chemicals in Code section 4682: (1) methyl bromide; (2) hydrochlorofluorocarbons (HCFCs); and (3) hydrobromadedfluoro-carbons (HBFCs).

TAX-EXEMPT ENTITIES

1. A proposal to deny Code section 501(c)(7) status to clubs that engage in discrimination (including gender discrimination) and to deny any preferential tax treatment for tickets to events at these clubs.

2. A proposal to tax political campaign committees of Federal candidates at the same rate of tax applicable to committees of State and local candidates -- i.e., at the highest corporate rate.

3. A proposal to impose a 30-percent excise tax on expenditures of tax-exempt organizations for lobbying (including amounts paid as salaries and an allocable portion of support costs).

4. A proposal to include contacts with regulatory agencies (except local land use agencies) in the definition of lobbying for purposes of the existing restrictions on Code section 501(c)(3) organizations.

5. A proposal to clarify, as in section 11408 of H.R. 3299 (as passed by the House in 1989), that an exempt organization that conducts overseas business activities through a foreign subsidiary will be subject to unrelated business income tax with respect to the subsidiary's Subpart F income (including actual as well as deemed distributions) if such income would be subject to tax if received by the exempt organization directly.

6. A proposal to extend the private inurement rule to organizations exempt from tax under Code section 501(c)(4).

COMPLIANCE

1. A proposal to require reporting of additional information to the Internal Revenue Service with respect to certain apportioned real estate taxes.

2. A proposal to increase estimated tax payments under the safe harbor method to 115 percent of last year's tax liability for individuals with adjusted gross income over $150,000.

3. A proposal to require written substantiation of any meal or entertainment expense claimed as a business deduction; alternatively, a proposal to require written substantiation of any meal or entertainment expense in excess of $10.

4. A proposal to deny corporations a deduction for all (or part) of interest paid to the Internal Revenue Service on tax underpayments.

5. A proposal to increase the rate of interest payable on corporate tax delinquencies.

6. A proposal to increase the rate of interest payable on under-payments of estimated tax for certain Alaska Native Corporations.

7. A proposal to require all companies in the trade or business of originating or acquiring loans to issue an information report to the debtor and to the Internal Revenue Service on any discharge of indebtedness in excess of $600.

(MORE)

8. A proposal to increase the rate of withholding on bonuses from 28 percent to 36 percent.

9. A proposal to increase the rate of withholding on gambling winnings from 28 percent to 36 percent.

10. A proposal to increase the rate of backup withholding from 31 percent to 36 percent.

11. A proposal to require taxpayers to file information returns if they purchase more than $600 of fish from any seller in a calendar year for the purpose of resale.

12. A proposal to extend for three years the Internal Revenue Service's offset authority for undercover operations under Code section 7608(c).

13. A proposal to extend permanently the special rule for disclosing information returns on cash transactions in excess of $10,000 to Federal agencies, State, local and foreign agencies for civil, criminal, and regulatory purposes.

14. A proposal to require the Internal Revenue Service to establish an on-line electronic transmission facility that payors can access on a dial-up basis to verify Taxpayer Identification Numbers (TINs).

MISCELLANEOUS ISSUES

1. A proposal to repeal the safe harbor under section 530 of the Revenue Act of 1978 (relating to the classification of workers as independent contractors) for construction industry employers.

2. A proposal to disallow deductions for compensatory damages under certain environmental laws.

3. A proposal to amend the like-kind exchange rules to require that the Code section 1031 property received must be "similar or related in service or use" to the property exchanged, except in the case of condemnations.

4. A proposal to disallow stock options as a qualifying expense for purposes of the research tax credit under Code section 41.

5. A proposal to provide anti-abuse rules with respect to the special rules under Code section 1071 applicable to deferral of gain upon the sale or exchange of property which the Federal Communications Commission (FCC) certifies is necessary or appropriate to effectuate a change in policy or the adoption of a new policy by the FCC with respect to the ownership and control of a broadcast station.

6. A proposal to clarify the treatment of environmental remediation costs by (1) specifying the types of such costs that must be capitalized, or, alternatively, (2) requiring that all such costs be amortized over a uniform period of years.

DETAILS FOR SUBMISSION OF REQUESTS TO BE HEARD:

Individuals and organizations interested in presenting oral testimony before the Committee on any of the proposals specifically described herein must submit their requests to be heard by telephone to Harriett Lawler, Diane Kirkland, or Karen Ponzurick [(202) 225-1721] no later than Wednesday, August 25, 1993, to be followed by a formal written request to Janice Mays, Chief Counsel and Staff Director, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. The Subcommittee staff will notify by telephone those scheduled to appear as soon as possible after the filing deadline. Any questions concerning a scheduled appearance should be directed to the Subcommittee [(202) 225-9710].

(MORE)

Persons and organizations having a common position are urged to make every effort to designate one spokesperson to represent them in order for the Subcommittee to hear as many points of view as possible. Time for oral presentations will be strictly limited with the understanding that a more detailed statement may be included in the printed record of the hearing (see formatting requirements below). This process will afford more time for Members to question witnesses. In addition, witnesses may be grouped as panelists with strict time limitations for each panelist.

In order to assure the most productive use of the limited amount of time available to question hearing witnesses, all witnesses scheduled to appear before the Subcommittee are required to submit 200 copies of their prepared statements to the Subcommittee office, room 1105 Longworth House Office Building, at least 24 hours in advance of their scheduled appearance. Failure to comply with this requirement may result in the witness being denied the opportunity to testify in person.

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CHANGE IN DATE

FOR IMMEDIATE RELEASE
THURSDAY, SEPTEMBER 2, 1993

PRESS RELEASE #11
SUBCOMMITTEE ON SELECT REVENUE MEASURES
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
1102 LONGWORTH HOUSE OFFICE BLDG.
WASHINGTON, D.C. 20515
TELEPHONE: (202) 225-1721

THE HONORABLE CHARLES B. RANGEL (D., N.Y.), CHAIRMAN SUBCOMMITTEE ON SELECT REVENUE MEASURES, COMMITTEE ON WAYS AND MEANS, U.S. HOUSE OF REPRESENTATIVES, ANNOUNCES RESCHEDULING AND ADDITIONAL SUBJECT FOR HEARING ON MISCELLANEOUS REVENUE-RAISING PROPOSALS

The Honorable Charles B. Rangel (D., N.Y.), Chairman, Subcommittee on Select Revenue Measures, Committee on Ways and Means, announced today that the hearing on miscellaneous revenue issues previously scheduled for Tuesday, September 14, 1993 (see Press Release #9, dated August 17, 1993, and Press Release #10, dated August 18, 1993), has been rescheduled for Tuesday, September 21, 1993. The hearing will be held in the main Committee hearing room, 1100 Longworth House Office Building, beginning at 10:00 a.m.

In addition, the Subcommittee will take testimony on September 21 on the following miscellaneous issue: A proposal to provide favorable tax treatment for the contribution of certain stock to a community foundation. The Subcommittee will not accept any further requests to present oral testimony.

WRITTEN STATEMENTS IN LIEU OF PERSONAL APPEARANCE:

Persons submitting written statements for the printed record of the hearings on September 8 and September 21, 1993, should submit at least six (6) copies by the close of business on Wednesday, September 22, 1993, to Janice Mays, Chief Counsel and Staff Director, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515.

FORMATTING REQUIREMENTS:

Each statement presented for printing to the Committee by a witness, any written statement or exhibit submitted for the printed record or any written comments in response to a request for written comments must conform to the guidelines listed below. Any statement or exhibit not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

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FOR IMMEDIATE RELEASE
TUESDAY, SEPTEMBER 14, 1993

PRESS RELEASE #12
SUBCOMMITTEE ON SELECT REVENUE MEASURES
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
1102 LONGWORTH HOUSE OFFICE BLDG.
WASHINGTON, D.C. 20515
TELEPHONE: (202) 225-1721

THE HONORABLE CHARLES B. RANGEL (D., N.Y.), CHAIRMAN SUBCOMMITTEE ON SELECT REVENUE MEASURES, COMMITTEE ON WAYS AND MEANS, U.S. HOUSE OF REPRESENTATIVES, ANNOUNCES ADDITIONAL DAY OF HEARINGS ON MISCELLANEOUS REVENUE-RAISING PROPOSALS

The Honorable Charles B. Rangel (D., N.Y.), Chairman, Subcommittee on Select Revenue Measures, Committee on Ways and Means, announced today an additional day of hearings on miscellaneous revenue issues. The hearing will be held on Thursday, September 23, 1993, beginning at 10:00 a.m., in room B-318 Rayburn House Office Building.

The September 23 hearing has been scheduled in order to accommodate the numerous requests to testify on the proposals set forth in press release #10, dated Wednesday, August 18, 1993, and press release #11, dated Thursday, September 2, 1993. In addition, the Subcommittee will receive testimony on September 23 on the following two miscellaneous issues: (1) a proposal to modify the predeceased-parent exclusion to the generation-skipping tax so that it (i) covers transfers to collateral descendants from a childless individual who outlives his or her own and subsequent generations and (ii) applies to transfers from a trust; and (2) H.R. 2971, a bill which would permit the recovery of certain overpayments of tax on disability payments received on severance from the military and which were held, by court decision acquiesced in the Internal Revenue Service, to be excluded from income under section 104 of the Internal Revenue Code.

In light of the large number of witnesses who have requested to testify, the Subcommittee will not accept any further requests to present oral testimony on the proposals that were described in press releases #10 and #11. Further, the Subcommittee advises witnesses that time for oral presentations will be strictly limited to no more than five minutes, with the understanding that a more detailed statement may be included in the printed record of the hearing.

DETAILS FOR SUBMISSION OF REQUESTS TO BE HEARD:

On the additional miscellaneous issues only, individuals and organizations interested in presenting oral testimony before the Committee on any of the proposals specifically described herein must submit their requests to be heard by telephone to Harriett Lawler, Diane Kirkland, or Karen Ponzurick [(202) 225-1721] no later than noon Friday, September 17, 1993, to be followed by a formal written request to Janice Mays, Chief Counsel and Staff Director, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. The Subcommittee staff will notify by telephone those scheduled to appear as soon as possible after the filing deadline. Any questions concerning a scheduled appearance should be directed to the Subcommittee [(202) 225-9710].

Persons and organizations having a common position are urged to make every effort to designate one spokesperson to represent them in order for the Subcommittee to hear as many points of view as possible. As indicated above, time for oral presentations will be strictly limited with the understanding that a more detailed statement may be included in the printed record of the hearing. (See formatting requirements below.) In addition, witnesses may be grouped as panelists with strict time limitations for each panelist.

In order to assure the most productive use of the limited amount of time available to question hearing witnesses, all witnesses scheduled to appear before the Subcommittee are required to submit 200 copies of their prepared statements to the Subcommittee office, room 1105 Longworth House Office Building, at least 24 hours in advance of their scheduled appearance. Failure to comply with this requirement may result in the witness being denied the opportunity to testify in person. (MORE)

WRITTEN STATEMENTS IN LIEU OF PERSONAL APPEARANCE:

Persons submitting written statements for the printed record for the September 23, 1993, hearing should submit at least six (6) copies by the close of business on Thursday, September 23, 1993, to Janice Mays, Chief Counsel and Staff Director, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. If those filing written statements for the record of the printed hearing wish to have their statements distributed to the press and the interested public, they may provide 100 additional copies for this purpose to the Subcommittee office, room 1105 Longworth House Office Building, before the hearing begins.

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FOR IMMEDIATE RELEASE
WEDNESDAY, SEPTEMBER 15, 1993

PRESS RELEASE #13
SUBCOMMITTEE ON SELECT REVENUE MEASURES
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
1102 LONGWORTH HOUSE OFFICE BUILDING
WASHINGTON, D.C. 20515
TELEPHONE: (202) 225-1721

THE HONORABLE CHARLES B. RANGEL (D., N.Y.), CHAIRMAN, SUBCOMMITTEE ON SELECT REVENUE MEASURES, COMMITTEE ON WAYS AND MEANS, U.S. HOUSE OF REPRESENTATIVES, ANNOUNCES AN ADDITIONAL ISSUE FOR HEARING ON MISCELLANEOUS REVENUE PROPOSALS

The Honorable Charles B. Rangel (D., N.Y.), Chairman, Subcommittee on Select Revenue Measures, Committee on Ways and Means, U.S. House of Representatives, today announced that the Subcommittee will add the following miscellaneous revenue issue to its hearing to be held on Thursday, September 23, 1993: H.R. 2617, the Military Separation Retirement Benefits Act, to provide that military separation pay can be rolled over tax free to an individual retirement arrangement (IRA).

Individuals and organizations interested in presenting oral testimony before the Subcommittee on the proposal specifically described herein must submit their requests to be heard by telephone to Harriett Lawler, Diane Kirkland, or Karen Ponzurick [(202) 225-1721] no later than noon Monday, September 20, 1993.

All other details for the hearing remain the same. (See press release #12, dated September 14, 1993.)

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Chairman RANGEL. Good morning. I apologize for any inconvenience that the delay has caused any members or witnesses. Today the Subcommittee on Select Revenue Measures will begin to receive testimony on a number of miscellaneous proposals for which members of the committee have indicated their interest. The chairman has referred these proposals to the subcommittee so that we can fully examine and the full committee can mark up any of the miscellaneous revenue legislation that is going to be considered here.

The hearings do not address the issues identified by Members that were included last year either in the House-passed version of H.R. 11, the Revenue Act of 1992, or in the miscellaneous bill that passed the House that were included in the conference agreement on H.R. 11. In addition, the hearings do not involve various revenue-raising provisions that Members have suggested to ensure that miscellaneous issues could be legislated on a revenue-neutral basis.

Hearing on the revenue offset will be announced at a later date. Today we will be hearing from Members of Congress on a wide range of issues and from public witnesses who have expressed interest in proposals relating to employee benefits, tax accounting, insurance, financial institutions, and cost recovery. I would like to welcome the distinguished Members of Congress and the public witnesses who have come to testify today. Because of the large number of issues that we have before us, we respectfully request that public witnesses limit their oral testimony to 5 minutes each. Without objection from members of the subcommittee, the full written statements of the witnesses will be entered into the record, and I will remind witnesses of that.

Before introducing our first witness, is there any statement, Mr. Hancock, that you would like to make?

Mr. HANCOCK. Thank you, Mr. Chairman. We are going to be hearing from, I think, 38 witnesses today, and I am certainly not going to delay the proceedings by launching into some long oration. I do wish to state, however, that I believe today's hearing, and those which will follow in coming weeks, are important in permitting Members of Congress to advance proposals of interest to them. I am hopeful the hearings will provide a genuine examination of the merits and flaws of these proposals.

Many of the proposals have obvious merit and should be adopted in time with due regard to some measure of stability in the tax laws. Many can attest to the importance of stability. Thank you very much.

Chairman RANGEL. Are there any members that wish to make an opening statement? Not hearing any, it is my distinct pleasure to introduce my friend and distinguished member of this august, awesome, and powerful committee, Mr. Sandy Levin.

STATEMENT OF HON. SANDER M. LEVIN, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MICHIGAN

Mr. LEVIN. Thank you, Mr. Chairman, Mr. Hancock, and my other colleagues. Mr. Chairman, I don't know if Mr. Camp, who has worked on one of these matters, wanted to intervene at this point.

Mr. CAMP. Mr. Chairman, if I might, I just want to in advance associate myself with the remarks Congressman Levin is about to make, particularly regarding section 842 in order to make it work

more fairly. I am an original cosponsor of H.R. 1228. There is bipartisan support for this measure. I have read your testimony, Congressman Levin, and I agree that it should be enacted into law. Thank you.

Mr. LEVIN. Mr. Chairman, since my statement is on the record, let me just briefly describe the three matters. The first was referred to by my distinguished colleague and friend from Michigan, and it relates to section 842(b) and the taxation of investment income of foreign insurance companies. The thrust of that provision was to make sure that they operated on a level playing field with domestic companies. The problem is that the way it was written it hasn't turned out that way, and they operate at a disadvantage because in calculating the complicated formulas, the taxpayer has to use 2-year-old domestic industry data. They are also required to use financial data rather than the domestic industry's tax data, so all this would do would be to require the use of current data that are likely to be more accurate.

We have worked over the years, and a colleague of ours—Mr. Vander Jagt and I worked closely on this together. We have worked with previous Treasury Departments. This proposal has been very substantially vetted. Indeed, I insisted on that before I agreed to participate. At all points there has been agreement that there was a problem with the present provision and it should be rectified. This has had the support, as I said, of the Treasury Department in the past, and also was carefully examined by Joint Tax Committee staff and was included in previous proposals that might be presented to the full Congress. This has never, though, survived to enactment for reasons other than its merits.

The second relates to the 10 percent excise tax on nondeductible contributions to qualified pension plans. The excise tax is intended to discourage abuse of qualified plans by the employers which might otherwise contribute and later obtain reversions and avoid taxation. There are a number of underfunded plans, and the excise tax can significantly increase the cost to the employer of funding these underfunded qualified plans. This proposal would eliminate the 10 percent excise tax, within limits which would assure that there could be no abuse.

The third relates to the R&E tax credit. I will just touch on this briefly, Mr. Chairman, because we have been working with Mr. Pickle on this. Because this is a larger matter, we were not able to consider it in the reconciliation bill. I just wanted to make sure that this was presented to you in the event there is an opportunity for us further to consider the R&E tax credit.

We, of course, extended the credit permanently in our reconciliation bill. For years some of us have been working on the issue of the R&E tax credit as it applied to research consortia. There are now a large number of them, and it is pretty clear from experience that we want to encourage these research consortia. This is an effort to do that. We have used various formulations. This one is a flat 20 percent tax credit. I think if all of us have an opportunity to look at this area in some detail, there would be very considerable agreement that we should further encourage research consortia.

This proposal, unlike the other two, would be very expensive, $1.5 billion. I have suggested ways to pay for the first two. This, however, could become implemented only as part of a larger consideration of the R&E tax credit. It does have broad support and recently was the subject of a bill that was introduced by Senators Bacchus and Danforth. I appreciate your time, and if there are any questions I would be glad to answer them. I know there will be further opportunities for all of us to work on these together, and you have a long list of witnesses, so I don't mean to take any more time. I appreciate these 5 or 6 minutes. Thank you very much.

[The prepared statement follows:]

Testimony of the Hon. Sander M. Levin
Before the Subcommittee on Select Revenue Measures
of the
House Ways and Means Committee
June 17, 1993

I appear before you today to support three proposals. The first would more fairly tax foreign insurance companies' investment income. The second would encourage employers to contribute to their underfunded qualified pension plans. The third would encourage cooperative R & E.

Effectively Connected Investment Income

The 1987 tax bill added Section 842(b) which changed the way foreign insurance companies' investment income is taxed. It uses information about the domestic insurance industry's investment performance to help determine foreign insurance companies' income taxes.

Section 842(b), in its current form, has three elements which cause it to operate unfairly and which I propose to correct. First, it requires the Treasury Department to use two year old domestic industry data. Second, it permits the Treasury Department to use the domestic industry's financial statement data, rather than its tax data. Finally, it contains no adequate carry-over provision to smooth out year to year fluctuations in investment performance.

My proposal, recently introduced as H.R. 1228, would require the Treasury Department to use same year data to calculate the domestic industry averages. It would provide for the use of tax return data, rather than financial statement data, in the calculations to the extent possible. Also, it would provide a fair carry-over procedure.

I think that if the original drafters had known of the problems inherent Section 842(b) they would have included these changes in the original bill. Because the unfairness and distortion caused by Section 842(b) were not intentional, I think this proposal is basically technical and I suggest that it be made retroactive to the time the section became effective. Modified in this way, Section 842(b) will serve its intended purpose well, but without the unfairness it causes in its current form. In fact, I have received correspondence from the Treasury Department stating that my proposal improves the operation of the section.

For these reasons I urge you to support this proposal.

Pension Contribution Excise Tax

The Tax Reform Act of 1986 imposed a 10% excise tax on nondeductible contributions to qualified retirement plans. The tax was intended to prevent employers from overfunding qualified plans and, possibly, obtaining a reversion of the plans' excess assets. It was an effective response to that abuse, but it has had a perverse effect when qualified plans are underfunded, as is now, all to often, the case.

This proposal would exempt from the excise tax certain nondeductible contributions to qualified plans, encouraging employers to fund their unfunded pension liabilities and to continue to contribute to their other qualified plans within permissible limits. This would increase the likelihood that workers and retirees will receive the full benefits they were promised and reduce the threat of increased liabilities facing the Pension Benefit Guaranty Corporation ("PBGC") and, ultimately, the Federal budget.

Today, many qualified plans are underfunded, including the plans of some of our largest employers. Underfunded plans have insufficient assets to meet their current obligations, threatening the security of covered workers and retirees. The PBGC stands behind qualified plans, but the PBGC's obligations to beneficiaries of failed plans are already testing its capacity. Moreover, the PBGC does not guarantee the full benefits promised by all plans.

It is in the interests of workers, retirees, the PBGC, the Federal government and the taxpayers for employers to fund the unfunded liabilities of their plans. Several major employers have expressed their intention to make these necessary, and very substantial, contributions. But in the years when employers make these large payments their total plan contributions will substantially exceed the deductibility limits. The excess contributions will not be deductible when made and will have to be carried forward. Each year the 10% excise tax will be assessed on nondeductible contributions. Perversely, the excise tax will substantially increase the cost to employers of these vital contributions.

Because the proposal would encourage employers to fund their underfunded plans, improve the security of beneficiaries and reduce the exposure of the PBGC, the government and the taxpayers, I think the cost is justified and I urge the adoption of the proposal.

Research Consortia

My third proposal would encourage collaborative R & E by modifying the R & E tax credit, which the House recently voted to extend permanently. I propose to grant participants in research consortia a 20% R & E tax credit.

There is little question that real economic growth is dependent on development and use of new science, innovation and technology. Today, R & E plays an even more critical role in our competitiveness. At a time when global competition is increasing, there is evidence that U.S. R & E has fallen for the first time in 20 years. Moreover, foreign companies seem to exploit new technology more quickly than U.S. companies.

This proposal, which embodies the substance of H.R. 3979 introduced during the 102nd Congress, would help to reverse this trend by providing a more generous credit for R & E conducted cooperatively by consortia of businesses. This incentive will not only result in more efficient use of scarce R & E funds, but will accelerate the integration of new technology throughout industry. It will stimulate new research and it could reduce duplicative activity which would otherwise be eligible for the incremental credit. Finally, it would encourage U.S. businesses to use teamwork to meet new challenges in the global trade environment.

On February 26, 1993 Senators Baucus and Danforth introduced S. 666, which parallels this proposal. The provisions of this proposal and S. 666 would work with the reinstated incremental tax credit by extending benefits to companies ineligible for incremental credits.

I ask for your support for this proposal.

Chairman RANGEL. OK.

Mr. LEVIN. Mr. Chairman, we just have received a formalized revenue estimate from the Joint Committee on Taxation that verifies earlier estimates, and I would like to submit it. I don't know, do these automatically come to you?

Chairman RANGEL. Which of those?

Mr. LEVIN. The revenue estimates.

Chairman RANGEL. The committee will get them.

Mr. LEVIN. Are they sent to you as well?

Chairman RANGEL. No, but the committee would have the revenue estimates.

Mr. LEVIN. OK.

Chairman RANGEL. I have been advised that the office would receive it if you requested it.

Mr. LEVIN. I will make sure that is done.

Chairman RANGEL. OK. In connection with your bill 1228, I understand it is supposed to be retroactive to the end of the year of 1987, and the question is why do you feel it is necessary to make it retroactive effective?

Mr. LEVIN. The main reason is that almost immediately it was understood that the way section 842(b) was being implemented was really not consistent with the intent of the Congress, and, I would say, of Treasury. So we have had a situation that was palpably unworkable or unfair almost from its inception, and we have been trying to change this for a number of years, so I think that a retroactive application would really be the most just result, but obviously that is subject to your consideration.

Chairman RANGEL. Well, obviously you are getting more than one estimate on this provision.

Mr. LEVIN. The estimate that I have and you will receive includes the retroactive provision. It is $115 million, and we have submitted for your consideration a revenue raiser that is essentially equivalent.

Chairman RANGEL. Do any members request an opportunity to question Congressman Levin? The Chair yields.

Mr. CAMP. Thank you, Mr. Chairman. I don't have a question, but I also would like to mention that the third proposal in Congressman Levin's statement I also feel is a worthy proposal, the R&E tax credit. Thank you.

Chairman RANGEL. Are there any other questions? Let me thank you for appearing before the committee.

Mr. LEVIN. Thank you very much, Mr. Chairman.

Chairman RANGEL. The Chair now calls another distinguished member of this committee, Mr. Clay Shaw.

STATEMENT OF HON. E. CLAY SHAW, JR., A REPRESENTATIVE IN CONGRESS FROM THE STATE OF FLORIDA

Mr. SHAW. Thank you, Mr. Chairman. My written statement is brief, so I will proceed with reading it to the committee. I first of all want to thank you, Mr. Chairman, and my colleagues for the opportunity to appear today in support of my proposal. The first one is to allow more than 35 stockholders in a subchapter S corporation, if all of the stockholders are members of the same family.

Under current law, a subchapter S corporation cannot have more than 35 shareholders. The 35-shareholder limit can cause a significant problem for family-owned businesses when multiple generations of a family are involved. If all the family members are made shareholders, the 35-shareholder limit may be exceeded. That leaves a family with an unenviable choice of losing subchapter S status or excluding some family members. This is true even when a family business has been operated for generations in subchapter S form but over time has grown beyond their 35 family members who want to participate in the business.

My proposal would solve this dilemma by providing that the 35-shareholder limit does not apply if all the shareholders are members of the same family. This proposal would promote one of the fundamental reasons why we have subchapter S corporations, to let family-owned businesses pick their own form free from taxing considerations.

Last year we included a provision in H.R. 11 which would have increased the subchapter S corporation limit from 35 to 50. That provision would have provided only a temporary relief for growing families in a subchapter S corporation. On the other hand, my proposal provides a permanent solution.

I also want to testify about this legislation introduced by Peter Hoagland and myself that would increase access to credit markets for businesses all across America.

In the interest of time, I will limit my remarks on this subject. By strengthening the market for asset-backed securities, this bill, H.R. 2065, would help borrowers who do not have access to capital, especially small businesses, and it would also help banks to diversify their investment while decreasing their credit exposure. In this effort we have received the endorsements of the American Bankers Association, the Public Securities Association, the Savings and Community Bankers of America, and the Securities Industry Association, among others.

I thank you for your time, Mr. Chairman, and would ask that the following attachments might be placed in the record along with my testimony.

[The prepared statement and attachments follow:]

STATEMENT OF THE HONORABLE CLAY SHAW
BEFORE THE SUBCOMMITTEE ON SELECT REVENUES
OF THE COMMITTEE ON WAYS AND MEANS

Mr. Chairman and Members of the Subcommittee:

I thank my colleagues for the opportunity to appear today. One of the subject matters on the Subcommittee's agenda today is of particular interest to me -- my proposal to allow more than thirty-five shareholders in a Subchapter S corporation if all of the shareholders are members of the same family.

As you know, currently a corporation cannot have more than 35 shareholders and still be eligible for Subchapter S status. The 35-shareholder limit can cause a significant problem for family-owned businesses when multiple generations of a family are involved. If all the family members are made shareholders, the 35-shareholder limit may be exceeded and Subchapter S status lost. If Subchapter S status is to be retained, some family members would have to be excluded as shareholders. This would even be true in the situation in which a family business has historically over generations run a successful enterprise in Subchapter S form but over time has simply grown beyond thirty five family members who wish to participate in the business. Why should a family be forced to choose a less desirable business form just because it has grown too large?

My proposal would solve this dilemma by providing that the 35-shareholder limit does not apply if all the shareholders are members of the same family. A family is defined as the lineal descendants of a common ancestor and spouses of such lineal descendants. Also, to ensure that real family ties exist, an individual can be considered a common ancestor only if he or she is not more than four generations removed from the youngest generation of shareholders at the time the Subchapter S election is made (or at the effective date of the provision for companies which have already made a Subchapter S election). My proposal is entirely consistent with one of the fundamental purposes of Subchapter S -- to allow family-owned businesses to choose their form free from tax considerations.

Last year, my concerns about family-owned Subchapter S corporations were addressed in part by a provision in H.R. 11 which would have increased the Subchapter S shareholder limit from 35 to 50 generally. However, for a growing family, a 50-shareholder limit may prove inadequate in the future. In turn, that would require us to consider this problem anew. In contrast, my proposal provides a permanent solution for businesses which are entirely family-owned.

I would like to thank the Subcommittee again for considering my proposal. Its adoption would go a long way in helping family-owned businesses by making available to them the same business organization options now available to 35 unrelated investors.

Public Securities Association
1445 New York Avenue, N.W.
6th Floor
Washington, D.C. 20005
(202) 434-8400 Fax (202) 737-4744

PSA

June 16, 1993

The Honorable Clay Shaw
2267 Rayburn House Office Building
Washington, D.C. 20515

Dear Congressman Shaw,

The Public Securities Association strongly supports H.R. 2065, the Financial Asset Securitization Investment Trust (FASIT) legislation and we want to thank you for introducing this measure.

As you know, the REMIC legislation that was included in the 1986 tax bill has been instrumental in facilitating the securitization of residential mortgages and we believe that FASIT will be just as useful in the asset-backed market by facilitating the securitization of loans, trade receivables and other financial instruments.

Securitization is a positive force in many markets as it creates liquidity, increases the availability of credit as well as decreases the reliance on bank credit and capital. The FASIT proposal will help borrowers who do not always have access to capital, especially small business and it will also help banks to diversify their investments while decreasing their credit exposure. As Congress and the Administration consider various options to stimulate the economy and ease the credit crunch, your proposal is certainly one of the solutions.

Looking at the investor side, there is a demand for a wide variety of securities tailored to individual needs and the securitization made possible by FASIT legislation will enable these demands to be met.

Again, we appreciate your willingness to introduce this legislation that we believe will be a tremendous help to the economy and look forward to working with you to get the FASIT proposal into law.

Sincerely,

Bonnie Caldwell
Vice President,
Government Affairs

John Vogt
Vice President,
External Affairs

LEHMAN BROTHERS

THOMAS A. RUSSO
MANAGING DIRECTOR

June 15, 1993

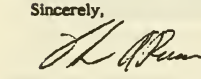
The Honorable E. Clay Shaw
2267 Rayburn House Office Building
United States House of Representatives
Washington, DC 20510

Dear Congressman Shaw:

I am writing in support of H.R. 2065, The FASIT Provision of 1993, which you introduced on May 11 and is the subject of a hearing before the Ways and Means Select Revenue Measures Subcommittee on Thursday, June 17. In our view, this legislation, if enacted, would facilitate lending to small and medium-sized business borrowers without increasing the direct and indirect exposure of the FDIC. The legislation will help provide the much needed capital by making the process of securitizing loans more efficient without reliance on governmental guarantees. By providing a pass-through tax regime for loan securitization similar to the highly successful mechanism for mortgage money, i.e., REMICS, borrowers will be able to finance their inventories, grow their business, and create new jobs, which will ultimately result in more tax revenues.

We commend you on your legislation and encourage quick action by the Congress. An identical letter is being sent to the co-sponsor of the legislation, Congressman Peter Hoagland.

Sincerely,



The First Boston Corporation
Park Avenue Plaza
New York NY 10055
Tel: 212 909-4939

Nelson Soares
Director - Asset Finance

June 15, 1993

Honorable E. Clay Shaw
U.S. House of Representatives
2267 Rayburn House Office Building
Washington, DC 20515

Dear Congressman Shaw:

As part of the financial services industry supporting H.R. 2065 - the Financial Asset Securitization Investment Trusts ("FASIT") proposal, we would like to take the opportunity to thank you for sponsoring these suggested changes to the tax treatment accorded to asset securitization.

As you may know, the public market for Asset Backed Securities ("ABS") has been a viable, stable and liquid funding source for many of the small and large companies who access the market. In addition, there are a substantial number of transactions done in the private placement market which also provide funding for institutions of all sizes. Recent changes in the securities rules have facilitated access to the ABS market for all issuers including banks, finance companies, retailers and others.

We happen to believe that the FASIT proposal would help increase the efficiency and ease of securitization for many of the participants in the ABS market in a revenue neutral manner. FASIT represents an extension of what is already available to the residential mortgage market to other categories of lending which will include commercial and consumer loans.

In conclusion, we would expect that FASIT would increase the availability of credit to and ability of companies of all sizes to borrow money in a cost effective and stream lined manner. If we can be of any further assistance please do not hesitate to call me at (212) 909-4939.

Sincerely,

Nelson Soares

Nelson F. Soares

Chairman RANGEL. On that last proposal, the FASIT proposal, do you think it would have any impact on the credit crunch?

Mr. SHAW. I think it definitely would because it would allow the bundling of these securities, which is very important, and would affect very favorably their marketability, so I think it is a very good consumer provision and would hope that it would be part of the committee's bill.

Chairman RANGEL. Thank you for your testimony. Are there any members who wish to inquire?

Mr. KOPETSKI. Thank you, Mr. Chairman.

Mr. Shaw, I commend you for bringing the proposal on the subchapter S family corporations to the committee's attention. I was one of the chief proponents, as you may be aware, last year of raising that corporate shareholder limit from 35 to 50. I think you are correct in saying that yours is really a permanent fix. If we just go to 50 in a few years, as families grow in this country, we are going to be up against this problem again.

One question I had, I know on the revenue estimate from last year's proposal it was less than $10 million, very insignificant to the Treasury. Are you aware of any change in that estimate?

Mr. SHAW. I would guess that the same estimate would probably carry forward. We will have to refine that before the bill is actually taken up by the committee, but I don't anticipate that the revenue impact would be substantially different from that we already have.

Mr. KOPETSKI. I look forward to working with you on this issue.

Mr. SHAW. Thank you very much. I appreciate your kind words and support.

Mr. KOPETSKI. Thank you, Mr. Chairman.

Chairman RANGEL. Is anyone else seeking recognition? The Chair would like to invite to testify a distinguished member of the Committee on Ways and Means, Congresswoman Nancy Johnson.

STATEMENT OF HON. NANCY L. JOHNSON, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF CONNECTICUT

Mrs. JOHNSON. Good morning, Mr. Chairman and members of the committee. I appreciate your time and I will be very brief. I do want to associate myself with the remarks of Congressman Levin, particularly in regard to the excess pension contribution proposal and the R&D tax credit for research consortia, although, of course, that is a bigger and more difficult issue.

I appreciate your interest in helping shed light on some relatively obscure tax problems that deserve legislative attention. Let me also take a moment to thank your staff and the Joint Committee for their professional treatment of these issues. I am here today to highlight two issues of considerable importance to me and my constituents: Item five under insurance on the committee press release and item two under cost recovery.

Since two of my constituents will testify on the technical aspects of these matters later today on panels three and six, I will not duplicate their efforts this morning. In regard to the first item, however, that deals with the ability of insurance companies to sell distressed real estate, let me highlight the terrible condition of commercial real estate in the Northeast. As many of you know, things are improving only glacially in my part of the country, and banks

and insurers are the unhappy owners of sizable portfolios of distressed commercial real estate.

Under current law, which is a vestige of the Tax Act of 1959, losses resulting from the sale of these troubled properties are treated as capital losses instead of ordinary losses that all other business taxpayers enjoy when selling real property at a loss. Thus the legislation I offer seeks to level the playing field for all commercial taxpayers who sell real estate at a loss; repeals a 34-year-old deadwood code provision; encourages prompt sale of real estate; and frees up working capital for more productive uses and enhances prospects for productive taxpaying use of currently troubled real estate.

I strongly urge the committee to support this provision and I will work with you to provide any additional information that you might need.

The second measure concerns the use of helicopters as trucks. Now, this may be a novel idea to those of us from urban areas, but in timber country helicopters are poised to play an increasing role in selective lumbering. At issue is the useful life of those helicopters and the importance of placing them on an equal footing with overland trucks that are far tougher on the environment. Already in very limited use, primarily in the Pacific Northwest, to lift thousands of pounds of timber out of deep forest, specifically designed helicopters, and for that matter all commercial helicopters, currently are depreciated over 7 years. I might add that larger planes are depreciated over 7 years. Yet land-based vehicles for this same use, that is logging, may be written off over 3 years.

In view of the environmental benefits of creating a level playing field for these aerial trucks as well as the positive defense conversion aspects of building more helicopters for civilian use, I strongly urge the committee to treat helicopters used in logging in the same manner as land-based vehicles. I would remind you that if you can selectively log, you can far better manage the Nation's land interests. Second, if you can selectively log by utilizing aerial logging, you save the expense of building roads and the environmental damage of those roads, and especially you are reducing the most damaging aspect of logging, which is dragging the logs out after they have been cut. This is not only a promising approach to saving the timber industry and helping the timber industry, but it also directly affects our ability to support defense conversion because the very people whose contracts are being cut out from under them by defense downsizing are also the folks who make the very heavy helicopters that are capable of this kind of workload, so it does meet a number of public policy concerns. And while the market for these vehicles is limited, it is an important market, and it will have an important revenue impact on a critical element in our industrial base.

Thank you very much for your attention. I would be happy to answer any questions. As I say, my constituents will testify in greater detail later in the morning.

[The prepared statement follows:]

NANCY L. JOHNSON
6TH DISTRICT, CONNECTICUT

COMMITTEE ON WAYS AND MEANS
SUBCOMMITTEES:
HEALTH
TRADE

COMMITTEE ON
STANDARDS OF OFFICIAL CONDUCT
CO-CHAIR
EXPORT TASK FORCE

Congress of the United States
House of Representatives
Washington, DC 20515-0706

WASHINGTON OFFICE
343 CANNON HOUSE OFFICE BUILDING
WASHINGTON, DC 20515-0706
TELEPHONE (202) 225-4476

NEW BRITAIN OFFICE
460 MYRTLE STREET—SUITE 200
NEW BRITAIN, CT 06053
TELEPHONE (203) 223-8412

ENFIELD OFFICE
278 HAZARD AVENUE
ENFIELD, CT 06082
TELEPHONE (203) 745-5722

STATEMENT BY REPRESENTATIVE JOHNSON OF CONNECTICUT

JUNE 17, 1993

SUBCOMMITTEE ON SELECT REVENUES

Thank you, Mr. Chairman and Committee colleagues. I appreciate your interest in helping shed light on some relatively obscure tax problems that deserve legislative attention. Let me also take a moment to thank your staff and the Joint Committee for their professional treatment of these issues.

I am here today to highlight two issues of considerable importance to me and my constituents; item #5 under Insurance on the Committee press release, and Item #2 under Cost Recovery. Since two of my constituents will testify on the technical aspects of these matters later today [Panels 3 and 6], I will not duplicate their efforts this morning.

In regard to the first item, however, that deals with the ability of insurance companies to sell distressed real estate, let me highlight the terrible condition of commercial real estate in the Northeast. As many of you know, things are improving only glacially in my part of the country and banks and insurers are the unhappy owners of sizeable portfolios of distressed commercial real estate.

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Under current law, which dates to the Tax Act of 1959, losses resulting from the sale of these troubled properties are treated as capital losses, instead of ordinary losses that all other business taxpayers enjoy when selling real property at a loss. Thus, the legislation I offer:

* seeks to level the playing field for all commercial taxpayers who sell real estate at a loss;
* repeals a 34-year-old "deadwood" code provision;
* encourages prompt sale of real estate and frees up working capital for more productive uses; and,
* enhances prospects for productive, tax-paying use of currently troubled real estate.

I strongly urge the Committee's support of this provision and I will work with you to see that it is approved by the House.

The second measure concerns the use of helicopters as trucks. Now, this may be a novel idea to those of us from urban areas, but in timber country, helicopters are poised to play an increasing role in selective lumbering. At issue is the useful life of those helicopters and the importance of placing them on equal footing with over-land trucks that are far tougher on the environment.

Already in very limited use - primarily in the Pacific Northwest - to lift thousands of pounds of timber out of deep forest, specially designed helicopters and, for that matter, all commercial helicopters, currently are depreciated over 5 years.

Yet, land-based vehicles used for the same purpose - logging - may be written off over 3 years.

In view of the environmental benefits of creating a level playing field for these aerial trucks, as well as the positive defense conversion aspects of building more helicopters for civilian use, I strongly urge the Committee to treat helicopters used in logging in the same manner as land-based vehicles. The market for these vehicles is very limited, so I anticipate that the revenue impact will be marginal.

Thank you very much for your attention to these issues.

Chairman RANGEL. Thank you, Mrs. Johnson. On your first proposal concerning life insurance companies, it really treats other type of business corporations, it will treat them all the same as relates to real estate?

Mrs. JOHNSON. That is really an equity issue.

Chairman RANGEL. Are there any questions from members of the committee? Anyone seeking recognition?

Mrs. JOHNSON. It is an equity issue, and I might say also it is an urban redevelopment issue because these concentrations of real estate are in the cities, and unless we can move that problem along, we just can't get business back on its feet in our urban areas.

Chairman RANGEL. Thank you, Mrs. Johnson.

The Chair is privileged to call the Honorable Sonny Montgomery to testify on behalf of our Nation's veterans. It is a pleasure and honor to have you here, Mr. Chairman.

STATEMENT OF HON. G.V. (SONNY) MONTGOMERY, CHAIRMAN, COMMITTEE ON VETERANS' AFFAIRS, AND A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MISSISSIPPI

Mr. MONTGOMERY. Thank you, Mr. Chairman, and members of the subcommittee. I would like to have my full statement put in the record, please, sir.

Chairman RANGEL. Yes.

Mr. MONTGOMERY. Mr. Chairman and members of the subcommittee, I want to thank you for including H.R. 786 on this morning's hearing agenda and for giving me a few minutes to speak in support of the legislation. I will try to be very brief, too, Mr. Chairman.

The language contained in our bill is identical to the language contained in the conference agreement on H.R. 11, which passed the Congress last year but was vetoed by the President. H.R. 786 has a single purpose, to clarify in the Internal Revenue Code the longstanding policy that veterans' benefits should not be taxed. That is the whole point of my testimony today.

Title 38 of the United States Code has long contained a provision clearly stating just that; however, because of an ill-conceived 1992 Internal Revenue Service general counsel opinion, which put in question the exempt status of certain benefits, we really think it is important to enact this bill. It is important to foreclose the possibility that through some legal reasoning, veterans' benefits somehow might be viewed as taxable in the future. Right now there is uncertainty among the veterans; two veterans groups will testify this morning before your subcommittee. We need to send them the message that there is no change in the Government's longstanding policy that all veterans' benefits are tax exempt.

In a letter to me in February, Chairman Rostenkowski recognized the importance of our bill but wanted to get the views of the administration.

I am pleased that President Clinton favors the enactment of legislation to accomplish this purpose. On May 17, Secretary of the Treasury Lloyd Bentsen, transmitted a draft bill to the Congress asking that it be favorably considered. This bill is basically the same bill I have introduced. Also, the Secretary of Veterans Affairs,

Jesse Brown, supports the enactment of this legislation. He deserves a lot of credit for getting the support of President Clinton on this issue.

Mr. Chairman, thank you for giving me this opportunity. I hope this bill would be included in the next tax bill. We are concerned about taxing the benefits of our veterans.

[The prepared statement follows:]

HONORABLE G.V. (SONNY) MONTGOMERY

CHAIRMAN, HOUSE COMMITTEE ON VETERANS' AFFAIRS

H.R. 786

Mr. Chairman and distinguished members of the Subcommittee, I want to thank you for including H.R. 786 on this morning's hearing agenda and for giving me a few minutes to speak in support of the legislation.

As you know, the language contained in our bill is identical to the language contained in the conference agreement on H.R. 11, which passed the Congress last year, only to be vetoed by the President. H.R. 786 has a single purpose: to clarify in the Internal Revenue Code the long-standing policy that veterans' benefits should not be taxed. Title 38 of the United States Code has long contained a provision clearly stating just that; however, because of an ill-conceived 1992 Internal Revenue Service General Counsel Opinion, which put in question the exempt status of certain benefits, we think it is important to enact this bill. It is important to foreclose the possibility that, through some tortured legal reasoning, veterans' benefits somehow might be viewed as taxable in the future. Right now there is uncertainty among veterans. We need to send them the message that there is no change in the government's long-standing policy that all veterans' benefits are tax exempt.

In a letter to me in February, Chairman Rostenkowski recognized the importance of our bill but wanted to await the views of the Administration.

I am pleased that President Clinton favors the enactment of legislation to accomplish this purpose. On May 17th, Secretary of the Treasury Lloyd Bentsen transmitted a draft bill to the Congress asking that it be favorably considered. This Administration is saying that veterans' hard-earned benefits should not be subject to federal income tax.

Secretary of Veterans Affairs Jesse Brown also supports the enactment of this legislation and he deserves much credit for gaining the support of the President on an issue that means so much to our nation's veterans.

Mr. Chairman, it is important to note that the enactment of H.R. 786 would have no adverse impact on revenues and I hope you will include the provisions contained in H.R. 786 in the next tax bill reported to the House.

Again, I thank the subcommittee for allowing me to appear this morning.

Chairman RANGEL. Thank you, Mr. Chairman. As you know, I agree with the thrust of your bill. In your prepared statement you indicated that we should note that the enactment of H.R. 786 would have no adverse impact on revenue. How do you reach that conclusion if indeed we are talking about a revenue raiser?

Mr. MONTGOMERY. The summary of the tax bill last year that had this provision in it showed that it would not take additional funds out of the Treasury. That was in the bill that was vetoed last year.

Chairman RANGEL. I guess you are saying that since it is not taxed now——

Mr. MONTGOMERY. That is correct, it is not taxed now, and so therefore—I guess a tax would bring in more revenue, but I hope it wouldn't be done.

Chairman RANGEL. I understand. Any members seeking recognition?

Mr. MCNULTY. Mr. Chairman, I don't have a question. I just want to welcome my former colleague from the Armed Services Committee and thank him for his continued strong and very effective advocacy on behalf of our Nation's veterans.

Mr. MONTGOMERY. Thank you very much.

Chairman RANGEL. And I would like to include myself in that number along with my son.

Mr. MONTGOMERY. Thank you.

Chairman RANGEL. Thank you, Mr. Chairman.

The distinguished chairman from the State of Massachusetts, Hon. Gerry Studds.

STATEMENT OF HON. GERRY E. STUDDS, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MASSACHUSETTS

Mr. STUDDS. Thank you very much, Mr. Chairman. I have seen your schedule and I will try to be mercifully brief.

I am here in support of a bill that I have introduced along with your colleague and mine, Mr. Neal, in the spirit of our former colleague Brian Donnelly, who had analogous legislation in years past to allow those taxpayers who itemize their deductions to deduct water and sewer fees charged by their local municipal governments. We actually, I think, have come up with an offset for the lost revenue, but I understand your subcommittee will take up revenue raisers at a later time.

As you all very well know, the Tax Code allows homeowners to take a deduction for the property tax they pay to their local government. This is the principal source of revenue for most of our country's municipalities. Using that revenue, the local governments provide their residents with essential public services, education, fire, police, roads, et cetera. In the past many communities also included the costs of water and sewer services quite logically in the property tax, but that, as I think you know, has changed in recent years for several reasons.

First of all, in response to tax limitation measures, some of the most famous of which were in California and in my own State of Massachusetts, communities removed from the property tax calculation the cost of water and sewer services and assessed them as

separate "fees" rather than as taxes. The IRS subsequently ruled that those fees, unlike the property tax, were not deductible.

In spite of the use of the word "fees," I think it is clear that water and sewer services are as much a part of essential government service as any other that is provided by general government, and that a fee is a tax no matter what we call it. Providing drinking water and transporting wastewater are fundamental, essential governmental activities, and these taxes, Mr. Chairman, as I think you know, have become extraordinarily burdensome in many American communities.

In the greater Boston area we now have family households whose annual water and sewer fees are in excess of $1,000 and believe it or not that is for a single normal household. They are projected to double in the next 3 or 4 years and possibly to rise substantially beyond that. There are other major areas around the country where analogous situations apply. It seems to me that these folks ought not to be denied the deduction that other Americans enjoy where local governments still cover the cost of basic water and sewer services through the property tax.

I think this proposal will bring fairness to the system by treating alike all of our citizens who itemize their deductions and pay for water and sewer services, whether they are included in the property tax or whether they are charged separately. I would say, Mr. Chairman, that we thought we had an accurate accounting of the cost of this proposition, but to my abject disbelief and delight we have just recently been given something that suggests the order of magnitude is less than its cost to the Treasury, so it has to be somewhere between the new one and the old one. At worst we thought it was approximately $100 million a year. It appears it may be substantially less than that.

In either event, we do think we have an offset when the proper time comes. I would urge you in simple fairness to folks around the country to allow this to proceed.

[The prepared statement follows:]

STATEMENT OF THE HONORABLE GERRY E. STUDDS
BEFORE THE SUBCOMMITTEE ON SELECT REVENUE MEASURES

June 17, 1993

MR. CHAIRMAN: I want to thank you for the opportunity to testify in support of H.R. 1973, legislation I have introduced that would allow taxpayers who itemize their deductions to deduct water and sewer fees charged by local governments. This week I am introducing a bill that provides an offset for the lost revenue, but I will not discuss this now since I understand the Subcommittee will take up revenue raisers at a later date.

As all of you know, the tax code allows homeowners to take a deduction for the property tax they pay to a local government. This fundamental tenet of tax policy has been in federal tax law since 1861. The tax, based on the value of the home, is the principal source of revenue for our nation's counties, cities and towns. Using this revenue, local governments provide their residents with essential services -- public schools, police and fire protection, road repair and many others.

In years past, many communities also included the costs of water and sewer services in the property tax. But that has changed in recent years.

In response to tax limitation measures such as Massachusetts' Proposition 2 1/2 or California's Proposition 13, communities removed from the property tax calculation the costs of water and sewer services and assessed them as separate "fees" rather than taxes. As you know, the IRS has ruled that these "fees" are not deductible.

Mr. Chairman, I use the word "fees" because that is what they are called by local governments. I would argue, though, that they are as much a tax as the property taxes that are deductible -- taxes that pay for essential government services like public education, and police and fire protection.

Water and sewer services are no different. Providing drinking water and transporting wastewater are fundamental governmental activities that have been carried on by municipalities for centuries. The first aqueducts to provide water to Roman citizens were constructed in 300 B.C. Wastewater drainage systems were built in Pompeii in the first century.

If it is appropriate tax policy and public policy to allow taxpayers a deduction for the property taxes they pay for some essential government services, it should also be appropriate to allow a deduction for other essential services, no matter what they are called.

These "taxes" -- and that is what they really are -- are not insignificant for many Americans. In fact, Boston area residents -- including many of my constituents -- will soon be paying more in water and sewer charges than in property taxes -- exceeding $1000 a year in many cases. They should not be denied the deduction that other Americans enjoy, those whose local governments still cover the costs of water and sewer services through the property tax.

You might say that the solution is for our municipalities to go back to the property tax to cover water and sewer costs. But it isn't that easy. First, the Clean Water Act prohibits local governments from using a property tax to pay for wastewater treatment projects. And, in some states, the tax limitation laws like Proposition 2 1/2 also prevent them from returning to a property tax to cover these costs.

My bill will bring fairness to the system by treating alike everyone who itemizes their deductions and pays for water and sewer services -- whether they are included in the property tax or whether they are charged separately. I can assure you that the cost of this proposal is relatively modest. According to a Joint Tax Committee estimate given to our former colleague Brian Donnelly, who introduced a similar bill in the last Congress, the loss to the treasury would be around $114 million for this fiscal year. We have proposed another change in the tax code that would pay for this and I would be glad to discuss this with you at a later date.

Thank you again for the opportunity to appear before you today.

Chairman RANGEL. I understand the fairness of the deductibility of sewer and water service to homeowners. I don't understand the fairness to urban dwellers who don't own their home as it relates to property taxes and now, sewer and water taxes and mortgage interest. How do you explain the fairness, if it can be explained, of those who live in apartments and they pay all of these expenses and the total is deducted by the owner, but they don't share in the returns, nonitemizers?

Mr. STUDDS. I hear you. I think what the Chairman is talking about is a broader question of the fairness of deductibility in general for renters who don't get direct advantage of all those things that are available to the owner of property, whether it is mortgage interest, or whether it is property taxes, or depreciation, or whatever it may be. That certainly is in your realm, a question of fundamentally broad tax policy. I don't think the suggestion before you rises to that level. I don't think it addresses that question.

It is simply saying that however you resolve that question, that among those things which are deductible certainly ought to be water and sewer fees.

Chairman RANGEL. Well, I appreciate your testimony. Are there any members that——

Mr. NEAL. Mr. Chairman?

Chairman RANGEL. Mr. Neal.

Mr. NEAL. Thank you, Mr. Chairman. First, Mr. Studds said that this legislation was being proposed in the spirit of Brian Donnelly. I want to announce I talked to him a couple of days ago, he didn't die. His spirit is pervasive in this chamber, but he didn't pass on. The issue that Mr. Studds has raised is particularly acute across New England now, and as a former mayor, I think I could speak with some knowledge of the argument that he made about essential services, and indeed many of the requirements that the Federal Government has offered have indeed raised the cost of these basic services. I believe that we have an obligation to offer some relief for what have become exorbitant fees in many parts of New England today, and I thank you for being good enough to entertain this proposal, Mr. Chairman.

Chairman RANGEL. Any others?

Mr. STUDDS. May I just thank my colleague from Massachusetts. I didn't mean for a second to suggest that Brother Donnelly had passed away, and besides, even if he had, that wouldn't disqualify him from membership in the Senate, so we always have that to look forward to.

Mr. NEAL. Guys like Donnelly never pass away. They are here forever.

Chairman RANGEL. Thank you very much, Mr. Studds. We will pass over Mr. Jefferson who is on the way here, and I will ask whether Mr. Torricelli—yes, he is. The distinguished Congressman from New Jersey, welcome to the Ways and Means Committee.

STATEMENT OF HON. ROBERT G. TORRICELLI, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NEW JERSEY

Mr. TORRICELLI. Thank you, Mr. Chairman, members of the committee, thank you for the opportunity to appear before you today. I am here to discuss passive activity loss rules which were enacted

in 1986. These rules were designed to prevent individuals from sheltering personal service income and portfolio income by deriving that income in corporate form and acquiring tax shelter investments at the corporate level.

Unfortunately, I believe there is an unintended and negative impact on certain privately held businesses in the field of equipment leasing that has put them at an enormous competitive disadvantage. I would like to both explain the reasons and to outline for the committee how I think this problem can be solved.

Under the passive activity rules, rent is treated as passive. One consequence is that the equipment leasing activities of a closely held private corporation are treated as a passive activity. That characterization is wrong in principle.

Section 465 of the code recognizes that an active equipment leasing business of a closely held corporation is not a tax shelter as long as it meets certain conditions. These conditions are that the company has at least three employees, five separate leasing transactions, and at least $1 million in gross receipts.

The erroneous treatment of equipment leasing by a closely held corporation as passive has at least two adverse consequences, each of which places small, privately held corporations at a disadvantage to larger, publicly held corporations engaged in exactly the same business, in exactly the same kinds of transactions. This clearly was not the intent of the committee.

First, by treating losses from an active leasing activity as passive, it subjects the equipment leasing activity to a passive activity loss rule, which improperly treats working capital as if it were portfolio investment of the individual.

In effect, this rule treats working capital of a private company just the same as if it were the individual's own resources. As such, a profit earned on working capital of a private company cannot be offset by a loss from the business.

Second, the unfair classification of an active equipment leasing activity under passive activity rules prevents closely held corporations from carrying back losses generated by the equipment leasing activities.

I do not believe that it was the intent of the passive activity rules to place closely held corporations at a competitive disadvantage to large, publicly held corporations.

To correct the above-mentioned inequity, it would be appropriate to allow closely held corporations to offset portfolio income against passive losses, as public corporations now do.

It would also be appropriate to amend the passive loss rules with respect to closely held corporations in the equipment leasing business to be consistent with the at-risk rules. This can be done by providing that an equipment leasing activity, treated as an active trade or business for purposes of the at-risk rules, will be treated as an active trade or business, and not a passive activity for purposes of the passive activity loss rules.

The revenue impact of this, Mr. Chairman, on closely held corporations to carry back would be minimal. Passive losses are now allowed to be carried forward indefinitely; whether they are carried back or forward, their total remains the same.

The offset of passive activity losses against portfolio income would also be expected to be minimal due to the relative small size of the companies in this category. A review of the membership of the Equipment Lessors Association reveals there are only 15 corporations in this business. Indeed, only two of them are of any size whatsoever.

I would strongly urge that the inequities created by this passive activity loss rule be eliminated by making the changes I have suggested. It is important that we do not allow unfair advantages to remain as an unintended consequence of the passive activity rules. I have suggested, Mr. Chairman, some language to the committee that would accomplish this. I would note Mr. Fazio has also submitted some testimony I believe will be in your record.

Mr. Chairman, in closing, clearly in eliminating a loophole in the law which allowed private investors to create a shell of leasing enterprises to offset their taxes, the committee acted appropriately in ending that activity and an enormous drain in resources. However, the distinction was false. What we wanted to do was separate real leasing activities that were generating economic activity in new equipment from those that were a mere shell. The way to do that was not to separate public corporations from private corporations, but real activities from those that were merely created for tax purposes.

In making this distinction, we took several large, important, privately held corporations and grouped them with the sham operations rather than with the large public corporations. The Tax Code now defends the appropriate activities of General Electric, Sumitomo, and a variety of large leasing corporations, but puts out of the business privately held, closely held corporations. My language would help those few corporations which as an unintended consequence of the 1986 law now are at an enormous trade disadvantage. Thank you, Mr. Chairman.

[The prepared statement follows:]

TESTIMONY OF HON. ROBERT G. TORRICELLI
BEFORE THE WAYS AND MEANS COMMITTEE, SUBCOMMITTEE ON TAXES 7/17/93

PASSIVE ACTIVITY RULES AS THEY APPLY TO CLOSELY HELD CORPORATIONS

Mr. Chairman, thank you for the opportunity to testify today. I am here to discuss the passive activity loss rules which were enacted by Congress in 1986. These rules were designed to prevent individuals from sheltering personal service income and portfolio income by deriving that income in corporate form and acquiring tax shelter investments at the corporate level.

Unfortunately, these rules have resulted in unintended and negative consequences which have put certain businesses in the field of equipment leasing at a competitive disadvantage.

Under the passive activity rules, rent is treated as passive. One consequence is that the equipment leasing activities of a closely held corporation are treated as a passive activity. That characterization is wrong in principle.

In fact, Section 465 of the Code recognizes that an active equipment leasing business of a closely held corporation is not a tax shelter activity as long as it meets certain conditions. These conditions are that the company has at least three employees, five separate leasing transactions annually and at least $1 million in gross receipts from equipment leasing per year.

The erroneous treatment of equipment leasing by a closely held corporation as passive has at least two adverse consequences. Each of these places a closely held corporation at a competitive disadvantage to larger publicly held corporations in the same business.

First, by treating losses from an active leasing activity as passive, it subjects the equipment leasing activity to a passive activity loss rule, which improperly treats working capital as a portfolio investment.

In effect, this rule treats working capital of a private company as if it were the same as a portfolio investment of an individual. As such, a profit earned on the working capital of a private company cannot be offset by a loss from the business.

A public company, on the other hand, is permitted to offset losses against income, including income from working capital. This gives the public company an unfair advantage over the private company.

For a public company, the code recognizes that working capital is a necessary part of a trade or business, and that it is inappropriate to treat interest income from bona fide working capital as unrelated to losses generated by the activity for which such working capital is maintained.

It is entirely appropriate for the passive activity rules to apply to a closely held corporation in an equal fashion.

Second, the unfair classification of active equipment leasing activities under passive activity rules prevents closely held corporations from carrying back losses generated by equipment leasing activities.

General net operating loss rules permit losses from a trade or business to be carried back as well as carried forward. The passive activity loss rules only permit a carryforward and not a carryback of the passive activity losses. This creates another unfair disadvantage for a closely held corporation in competition with a publicly held corporation, which operates under the general net operating loss rules.

I do not believe that the intent of the passive activity rules was to place closely held corporations at a competitive disadvantage to publicly held corporations.

To correct the above mentioned inequities, it would be appropriate to allow closely held corporations to offset portfolio income against passive losses, as public companies do now.

It would also be appropriate to amend the passive loss rules with respect to closely held corporations in the equipment leasing business to be consistent with the at risk rules. This can be done by providing that an equipment leasing activity treated as an active trade or business for purposes of the at risk rules will also be treated as an active trade or business, and not a passive activity, for purposes of the passive activity loss rules.

The revenue impact of allowing closely held corporations to carryback passive losses would be minimal. Passive losses are now allowed to be carried forward indefinitely; whether they are carried back or forward, their total remains the same.

The offset of passive activity losses against portfolio income would also be expected to be minimal due to the relative small size of companies in this category in the equipment leasing business. A review of the membership of the Equipment Lessors Association reveals approximately 15 companies which may be affected by this provision.

I strongly urge that the inequities created by the passive activity loss rules be eliminated by making the changes I have outlined above. It is important that we do not allow unfair advantages to remain as consequences of passive activity rules. We must ensure that all corporations involved in equipment leasing have equal opportunity in the field.

Chairman RANGEL. Thank you for bringing this inequity to our attention. There have been some major reforms in the House-passed reconciliation bill. I don't know whether it directly affects your issue, but if it does not, do you have any idea of the revenue impact of your provision?

Mr. TORRICELLI. Mr. Chairman, indeed there are only 15 private family companies that are at a disadvantage unintendedly because of this. Only two of those are substantial in the business. It is our estimate that the total revenue impact is less than $1 million.

Now, committee staff may appropriately note that if we open this door to privately held corporations we could recreate the pre-1986 problem by a variety of people creating false enterprises for tax purposes. One way to avoid that is we can simply raise the threshold. I have suggested a threshold that you must have at least three full-time employees, a certain number of contracts totaling $1 million in leases every year.

If the committee staff believes that would still invite people to enter the business, who are not interested in the equipment leasing business but only interested in the tax consequences, we can raise that. The two corporations are similar in size to the large publicly held corporations, so the level of the threshold is not at issue. Any threshold, I think, would be appropriate. We are not intending to open this up to sham operations, only to get equity between the private and the publicly held corporations, so the revenue estimates are minimal.

Chairman RANGEL. Mr. Hancock.

Mr. HANCOCK. Are you aware that an individual now gets that kind of treatment? A lot of people for years reported their—if they have individual leasing, they reported it on the real estate side. The Internal Revenue Service now allows those transactions to be rebated as business income. This allows the transaction not to be subject to passive loss rules. So I think that what you are talking about doing is only equitable because individuals now do get that type of treatment.

Mr. TORRICELLI. And I am sure it was never the committee's intention to create a false category of tax advantages for—whether you have stockholders or you happen to own your company privately. I am sure the committee intends to be neutral on that subject. People can organize their companies as they see fit. It is simply a question of whether it is generating appropriate and favorable economic activity for the country. That is where the threshold should be.

Mr. HANCOCK. Were you aware that the Internal Revenue Service has changed its regulations?

Mr. TORRICELLI. I am aware of that.

Mr. HANCOCK. Fine.

Chairman RANGEL. Are there any other questions for Congressman Torricelli?

Mr. TORRICELLI. Thank you very much, Mr. Chairman, members of the committee.

Chairman RANGEL. The Chair is now privileged to recognize Congressman Bill Jefferson from Louisiana, a member of the Ways and Means Committee.

STATEMENT OF HON. WILLIAM J. JEFFERSON, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF LOUISIANA

Mr. JEFFERSON. Thank you very much, Mr. Chairman, and I appreciate your indulgence and that of the committee in permitting me to speak to the committee somewhat out of order. Inasmuch as I wasn't on the original program, I truly appreciate your permission. I want to talk to the committee about the capital construction fund program which, as the committee may know, offers deferment of Federal income taxes on deposits into the capital construction fund and assists owners and operators of U.S.-flag vessels to construct and modernize their vessels.

Currently, the program is limited to vessels constructed for the foreign, Great Lakes or noncontiguous domestic trade. The CCF program should be expanded, in my view, Mr. Chairman, to apply to the passenger vessels operating in any U.S. domestic trade, including inland waterways. The CCF program encourages and assists the construction of U.S.-flagged vessels through the deferment of Federal taxes. Deposits into a CCF are exempt from current Federal taxation. In return, a company's tax basis in a new vessel is reduced, thereby reducing depreciation deductions the company may take over time so that the Government gradually recoups its taxes.

Under the CCF program, eligible vessels produce income which may be deposited to the CCF. Qualified vessels are those new vessels for which withdrawal may be made from the CCF. Eligible vessels may operate anywhere and their earnings be deposited into a CCF. Currently, however, and this is the gravamen of the problem, withdrawals from the CCF to help construct a qualified vessel may only occur if that vessel is operated in a U.S. foreign, Great Lakes, or noncontiguous domestic trade, but not in other domestic trades. The limitation on permitting the CCF program to be used to construct vessels in the coastwide and inland domestic trades apparently was imposed out of a concern that it would unjustly advantage barge operators in competition with rail and truck transportation, and, in fact, previously it did spawn an interest in investing in barges as tax shelters, which had no real economic value, but unfortunately the result also has been not just to preclude barges, but to preclude the use of the program to help finance passenger vessels' construction.

In order to include passenger vessels constructed for the domestic trade in the CCF program, the definition of a qualified vessel for purposes of the CCF program needs to be expanded. Note that because the CCF program has been codified both as section 607 of the Merchant Marine Act from 1936 and as section 7518 of the Internal Revenue Code, any changes to the CCF program must be made both to the Merchant Marine Act and the IRC, Internal Revenue Code. This means that the sections of both the Internal Revenue Code and the Merchant Marine Act, which rely on the definition of qualified vessel, must be amended to incorporate the expanded definition of qualified vessel in section 607(k).

The construction and operation of new U.S. passenger vessels will create many new jobs throughout our country, not only in shipyards and aboard the vessels, but also in the urban waterfront areas where the vessels call. Today the vacation cruise business is

dominated by a handful of foreign companies operating foreign-flagged vessels in the foreign trade. U.S. companies want to provide cruises on U.S.-flagged vessels operating in the domestic trade, such as between U.S. ports or along the Mississippi River. In order to compete effectively, however, these companies need access to the CCF. Providing them with such access is consistent with the policies underlying the CCF, to offset foreign competitors' tax advantages.

Last year the Treasury Department and the joint Tax Committee estimated that the revenue lost from extending the CCF program to all vessels operating in the domestic trades would cost no more than $2 million annually. Passenger vessels are only a small part of that universe, so the cost ought to be fairly negligible.

I want to thank you, Mr. Chairman, again for giving me the opportunity to present this statement before the subcommittee and I want to thank the committee for paying as close attention as I notice it has to my statement. Thank you very much.

Chairman RANGEL. Thank you, Mr. Jefferson. Why are you restricting access to the CCF to passenger when you have an estimate for all vessels operating in domestic trade?

Mr. JEFFERSON. Well, we were citing an estimate made by the Treasury Department to indicate how nominal it would be to deal with passenger vessels only because that estimate was for all vessels, which I suppose would include barges and the rest, which we don't plan to get into. We are trying to expand the opportunity for U.S.-flagged carriers to get involved in the booming tourist trade that is going on. It will spur shipbuilding, as I said, in the shipyards around our country that are fairly dormant, and it will provide jobs at urban areas where the ships call as well as on board it will provide jobs for those who man the ships.

Chairman RANGEL. Where is the provision to expand what is the definition of a qualified vessel in Merchant Marine and Fisheries?

Mr. JEFFERSON. As I appreciated, the committee has already passed it, supported by the Merchant Marine and Fisheries Committee, which has supported legislation, H.R. 2152, including such a change, so apparently the committee has already acted on it.

Chairman RANGEL. Did they restrict it to passenger or all vessels in domestic trade?

Mr. JEFFERSON. As I appreciate it, it is restricted to passenger vessels.

Chairman RANGEL. Thank you. It seems like it makes a lot of sense. Are there any other questions? Thank you.

Mr. JEFFERSON. Thank you, Mr. Chairman.

Chairman RANGEL. From the State of Oregon we have Congressman Peter DeFazio.

STATEMENT OF HON. PETER A. DeFAZIO, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF OREGON

Mr. DEFAZIO. Thank you, Mr. Chairman. I thank the committee for its grant of time here to discuss H.R. 1997. Excuse me, I am behind in time. I will summarize my remarks in the interest of time because I know the committee is going to hear from a lot of people today.

H.R. 1997, as I have introduced it, has a couple of objectives. It is a bill to restore some favorable treatment to people who engage in the very risky and long-term act of growing timber for future harvest. The 1986 Tax Act with the passive loss limitations basically removed any tax benefit, particularly from small woodland owners, and restricted tax benefits even to corporate owners for growing timber.

Now, growing timber is an activity that in my part of the woods, you know, 30 to 50 years for a merchantable product, and we have an extraordinary shortage of logs in our region, so I think it would both meet a national objective, objectives that I think we will hear more about from President Clinton later in his comprehensive forest package, and a regional objective in terms of restoring some favorable treatment to that and encouraging the production of timber on private lands. My bill also goes a bit further, however. It also, in restoring the capital gains and passive loss or modifying the passive loss rules and restoring a modest capital gains break of up to 30 percent for selling of timber, pays for this by rescinding the foreign sales corporation provisions for timber, and in particular a few corporations have taken advantage of FSC to export raw logs overseas and shelter part of that income through an FSC.

President Clinton has said that he would like to see this provision repealed, and I would hope that members of the committee will look favorably at that as a financing mechanism. Finally, my bill differs from that introduced by a member of the committee, Representative Kopetski, and Representative Wyden of Oregon in that I add one further provision to my bill to help bring it closer to revenue neutrality, which is I would limit the tax advantages in terms of capital gains to persons who grow their timber for sale and manufacturing in the domestic market.

We already require that Federal logs be manufactured in the domestic market. The State of Oregon and the State of Washington require that in whole or in part of Oregon, and in part in the State of Washington, that their State logs be manufactured in the domestic market. There is a tracking system set up by the Federal and State markets in order to ensure that there is compliance. It would not be difficult at all for the Federal Government to track logs grown on private lands and be certain that if people were going to claim the special tax treatment that we got the maximum value-added return from those logs by manufacturing them in the domestic market. This would help with the timber shortage we are experiencing in the Pacific Northwest.

I would hope that the committee will look favorably upon this legislation and, as I said earlier, put my entire statement in the record. I make myself available for any questions the committee might have.

[The prepared statement follows:]

The Statement of
the Honorable Peter DeFazio
before the
Subcommittee on Select Revenue Measures
of the
Committee on Ways and Means
June 17, 1993

Mr. Chairman and members of the committee: I want to thank you for agreeing to hold a hearing today on H.R. 1997, bipartisan legislation I have introduced to increase the supply of timber for America's wood products manufacturers.

Let me tell the committee why H.R. 1997 is important to the Pacific Northwest and the nation. Last year, 2.2 billion board feet of raw logs were exported to the protected economies of the Far East from ports in Oregon and Washington alone. Every year since 1980, between 20 and 25 percent of the total timber harvest in Oregon and Washington has been exported in unprocessed form. Though gross volumes are declining, the percentage of total harvest that is exported has remained the same over time.

There are about 16,000 inefficient sawmills in Japan alone. Yet Japan harvests virtually none of its own forest resources. Those mills are working overtime processing softwood from the U.S. and hardwoods from the few nations in the Pacific that still allow unprocessed timber exports to Japan.

The Pacific Northwest's wood products manufacturing base consists of about 340 highly efficient mills. Many of these mills are on the brink of failure because of severe reductions in timber supplies from federal forests in the region. Our mills could easily outcompete the Japanese on their own turf if Japan's trade rules were not skewed against us, and if these mills had a reliable source of raw material.

H.R. 1997 is intended to level the playing field -- to give U.S. timber growers an incentive to sell to domestic processors, and give U.S. companies a little help as they compete with Japanese buyers who have the advantage of a strong Yen and a protected domestic market.

H.R. 1997 does two things: it eliminates a tax break benefitting corporate log exporters, and uses the savings to fund a targeted tax break -- a restoration of capital gains for tree growers who sell their product for domestic manufacturing.

Specifically, H.R. 1997 would disqualify unprocessed timber for the benefits available to exporters who sell their timber through foreign sales corporations or domestic international sales corporations. It also amends the title passage rule to make absolutely sure that the income from the sale of timber cut in the United States is

taxed as U.S. income. Mr. Stark, a distinguished member of the Committee on Ways and Means, deserves a great deal of credit for his work on this section of the bill.

The Joint Committee on Taxation estimates that these log export subsidies cost the federal Treasury about $80 million a year. Mr. Chairman and members of the committee, the U.S. taxpayer should not be asked to subsidize the export of raw logs and jobs.

My bill uses the savings from eliminating these subsidies to largely offset the cost of a limited restoration of capital gains for timber -- but only timber that is sold for domestic manufacturing. Specifically, a timber grower can deduct two percent of the value of the timber from his gross income for each year he has held the timber, up to a maximum 30 percent deduction. Allowing this deduction would substantially restore cpaital gains to their pre-1986 condition for timber that is sold for processing in U.S. mills.

I've asked the Joint Committee on Taxation to provide a revenue estimate for H.R. 1997, but the work is not yet completed. However, the committee completed revenue estimates for an earlier and nearly identical bill I introduced, H.R. 664, as well as for a bill introduced by Reps. Wyden and Kopetski that lacked a domestic processing requirement. Using these estimates as a guide, it's probably safe to say that H.R. 1997 would cost the Treasury about $30 million a year.

I would argue that the taxpayers will be rewarded many times over for this modest investment in their domestic wood products manufacturing industry. But if the committee so chooses, it would be relatively easy to make this bill revenue neutral, while maintaining its integrity. I would be happy to work with the committee on this matter.

In closing, I would like to point out that my bill is strongly supported by the National Association of Homebuilders, the United Brotherhood of Carpenters and Joiners, the Western Forest Industries Association and the Northwest Independent Forest Manufacturers.

All of these groups recognize the importance of stable domestic supplies of lumber and other wood products. They know how important the timber industry in the Pacific Northwest is to the economic health and vitality of this nation.

But the benefits of my bill are not limited to the Northwest; they are national in scope. I urge the committee to support H.R. 1997.

Chairman RANGEL. Thank you. Do you have a revenue estimate in terms of what——

Mr. DEFAZIO. Well, I am still waiting for the Joint Tax folks to come back with a formal estimate, but in looking at the estimates they provided to Representatives Kopetski and Wyden in estimating the number of folks who would not be claiming the benefit because of export, I estimate that the potential cost is somewhere around $30 million a year. But I believe there are a number of ways that we could easily get that to revenue neutrality, in particular if we excluded the first 5 years of the holding period for timber and said until you have held timber for at least 5 years you can't claim any reduction in tax. And the estimates we have done show that if you put in a 5-year holding period, we would achieve revenue neutrality.

Chairman RANGEL. There are any number of proposals to index the capital gains tax for inflation. Would that give you any relief at all?

Mr. DEFAZIO. I think indexation would provide some relief. We have approached it slightly differently. Timber values vary so dramatically according to the market, the housing market, final demand, year by year, we are at record prices right now. A few years ago we were at rather low prices, so obviously, you know, indexation, depending upon the fluctuations of the market could provide some relief, and is another approach that I believe has been introduced in legislation in the past.

We just chose a slightly different method which is in order to encourage a certain holding period we give the 2 percent per year up to 15 years.

Chairman RANGEL. Does the timber industry enjoy a differential, a favorable differential now in the way we treat capital gains?

Mr. DEFAZIO. Not to the best of my knowledge, Mr. Chairman. My understanding is that was eliminated, with the exception of the people taking advantage of FSC by the 1986 Tax Act.

Chairman RANGEL. In your research do you know of any industry that receives different treatment of capital gains?

Mr. DEFAZIO. Different treatment of capital gains?

Chairman RANGEL. Favorable treatment. What I am really getting at is I don't even know to what we are exposing ourselves, no matter how meritorious your argument is.

Mr. DEFAZIO. I understand.

Chairman RANGEL. Well, this is just a technical point here. You did provide an offset for your provision, didn't you?

Mr. DEFAZIO. An offset would be the FSC repeal, foreign sales corporation repeal, and then again, as I say, if you introduced a 5-year minimum holding period we would achieve revenue neutrality in our estimates, although we don't have a formal estimate back yet.

Chairman RANGEL. Well, I have been advised by staff that you have to get another offset, that the Senate stole yours in yesterday's bill.

Mr. DEFAZIO. Well, Mr. Chairman, I am certain that this committee is going to stand up for its prerogative and not let those Senators dictate to you how and when we should use the FSC repeal to benefit the United States of America.

Chairman RANGEL. Thank you so much.

Mr. KOPETSKI. Mr. Chairman, just briefly. My colleague from Oregon has brought a good issue to this committee. We agree on about 90 percent of this package. It is the issue of should there be a domestic preference for trees or not, and this isn't the forum to debate that. In advocacy for different treatment of capital gains for growing timber in this country, this is different from erecting a steel mill or any kind of high technology investment.

Trees take 60 to 80 years minimum to grow. Because of all of the Federal laws coming down on the private timber growers, with spotted owls and other kinds of varmints that can take away this timber value, we want to encourage people where they do harvest to grow trees again. It is very simple to turn this land into some other kind of production, whether it is a corn field or a development. We need this fiber for building houses in downtown New York City or any other place in this country, and if you talk to your home builders you will see that we try to erect low-income housing in this country. The price of timber alone is going to make that difficult.

Now, the Senate has in its wisdom stolen the money, if you will, from the timber industry and used the moneys for other provisions in the Tax Code. I think Pete and I and the entire Northwest delegation, and others from timber States, the Southeast, for example, would say, look, this FSC money ought to stay in a timber-related area, whether it is in the capital gains area, whether it is in community assistance, because of what the various environmental laws are doing to the communities. They need some assistance and diversification, et cetera.

Pete and I worked together on this issue. I don't think at this stage we should take the approach that we no longer have the funds available to us. The members of this committee have the ability to work their own wisdom on how the revenue raiser might be utilized.

Mr. DEFAZIO. Mr. Chairman, if I might, I was thinking about your earlier question. I think it was in the President's proposal—perhaps it was not approved by the committee—but wasn't there some favorable treatment extended to investments in startup companies or small capital companies in terms of capital gains?

Chairman RANGEL. Yes. They wiped that out, too.

Mr. DEFAZIO. OK. When you asked for examples, that is one I could think of.

Chairman RANGEL. Are there any other questions?

Thank you so much.

Mr. DEFAZIO. Thank you, Mr. Chairman.

Chairman RANGEL. The Chair welcomes the Congressman from Illinois, Mr. Costello. We have a vote going, but I think we can get this testimony in. By unanimous consent, your statement is in the record in its entirety.

STATEMENT OF HON. JERRY F. COSTELLO, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF ILLINOIS

Mr. COSTELLO. Mr. Chairman, thank you. I will be very brief. I have submitted a statement for the committee and for the record. I want to thank the committee for allowing me the opportunity to

be here and the members of the committee, particularly the chairman and Mr. Payne, who has been supportive of this legislation.

H.R. 142 is not only important to me and my constituents in southern Illinois, but also to all of our constituents in every congressional district throughout the United States.

In October 1991, the House passed the landmark legislation, the ISTEA transportation bill. One result of that legislation will be that land, property will be taken by local governments to make way for new highways, bridges, and other transportation projects.

What this bill does is deals with the inequity, in my judgment, that now exists between an involuntary sale of property through the right of eminent domain by local governments, as opposed to a person who wants to sell, is a willing seller of property.

As you know, an individual who willingly sells a piece of property is subject to a 28-percent capital gains tax. The situation where there is an involuntary seller and a government comes in, says we want to build a highway, a bridge, or an airport so we are taking the land by way of eminent domain powers, that person is forced to invest in a like-kind property.

As an example, in my district, there is an airport going in, as there is in Chicago and other places; farmers and other people are told we are coming in, going to take your farm and compensate you for that; but in order to defer the capital gains tax, that person has to go out and buy another farm, a like kind of property.

This bill would eliminate that inequity and address that issue. The Joint Committee on Taxation has indicated that there is a very minimal impact on the Federal budget, to the extent of about $5 million per year. We have offered offsets to this committee for consideration.

I would be happy to answer questions.

[The prepared statement follows:]

JERRY F. COSTELLO
12TH DISTRICT, ILLINOIS

PLEASE RESPOND TO THE OFFICE CHECKED BELOW:

COMMITTEES:
BUDGET
PUBLIC WORKS AND TRANSPORTATION
SCIENCE, SPACE, AND TECHNOLOGY
(ON LEAVE)

Congress of the United States
House of Representatives
Washington, DC 20515-1312

TESTIMONY OF

THE HONORABLE JERRY F. COSTELLO

ON H.R. 142

SUBCOMMITTEE ON SELECT REVENUE MEASURES

JUNE 17, 1993

Mr. Chairman and Members of the Committee, I want to thank you for giving me an opportunity to testify on legislation I have introduced to ease the burden of eminent domain on our nation's taxpayers. This bill, H.R. 142, is very important to me, to my constituents in Southern Illinois and to property owners in every congressional district across our nation. I would also like to sincerely thank Congressman L.F. Payne for his support of my bill and for his assistance in moving this legislation through the Ways and Means Committee.

In October of 1991, the House passed landmark transportation legislation which will dramatically redirect the nation's infrastructure investment over the next six years. One result of this legislation is that thousands of land owners nationwide will have their property condemned by local governments to make way for a new highway, bridge or other transportation project.

As all of you are aware, under present law, this involuntary conversion of property forces land owners to make a difficult choice: they must either pay the tax on their capital gain that year, or defer the tax by investing the gain in similar or like-kind property. Current law allows them up to three years in which to find similar or like-kind property.

Unfortunately, the eminent domian process places an undue burden on these land owners, who along with losing their land, face the immediate challenge of finding similar land in which to invest. To force these land owners to search for identical property to purchase is unfair and unreasonable, especially since they were unwilling sellers in the first place.

H.R. 142 alters the law to allow land owners who own property for 10 years or more, and whose property is taken by eminent domain, an opportunity to re-invest that gain in any property to defer this tax.

This bill will allow property owners who have had their land taken for public use - many of whom have owned it for generations - the opportunity to place that gain in any investment, such as a small home, a stock portfolio or a retirement investment fund, to defer the immediate tax penalty on that capital gain. By offering this flexibility, we restore some fairness to our tax code for these unwilling sellers.

For example, in my congressional district, in Chicago, and across our nation, airports will be expanded in coming years to allow for greater aviation capacity. Throughout our country, new highways will be built to prepare for the transportation needs of the 21st century. This process will require land to be taken from property owners by eminent domain. Many of these land owners will merely want to convert their gain into an investment for retirement, and not be forced to buy more similar property to avoid the capital gain penalty.

Because H.R. 142 has been confused with the like-kind exchange issue, I would like to emphasize the differences between this legislation and the deferment of gain in a like-kind exchange. In most cases, the taxpayer involved in an eminent domain situation did not want to convert his property in the first place and suffers financial loss as a result. The land owner often ends up paying the capital gains tax on the proceeds

of the conversion because he cannot meet the qualified property replacement definition.

However, in a like-kind exchange, the taxpayer wants to exchange his property. As a result, few like-kind exchange transactions fail because suitable replacement property cannot be found.

Further, a taxpayer involved in an eminent domain proceeding has no control over the timing of the transaction. In a like-kind exchange, the taxpayer completely controls the timing.

A very positive aspect of this legislation is its minimal impact on the federal budget. The Joint Committee on Taxation has estimated that H.R. 142 will decrease federal budget receipts by less than 5 million dollars annually. However, to offset this decrease, I have proposed a very minor tightening of like-kind exchange rules.

In conclusion, I know we are all well aware of the controversy that involves the eminent domain process and the public outcry that results from government "taking" land for a new highway, airport or other transportation project. This bill eases the burden on land owners and gives them an opportunity to place their gain in a more accessible investment.

Again, Mr. Chairman and Members of the Committee, thank you for your attention. I hope you agree that this is an issue that needs to be addressed by including the legislation in the next tax bill reported out of this Committee.

Chairman RANGEL. Are there questions?

Mr. PAYNE. I would like to commend my colleague, Mr. Costello, for bringing this bill to us and, as he mentioned, I am a supporter of this bill. I have questions. I will submit those. Perhaps you can answer those for the record.

[The information follows:]

Questions proposed by Congressman Payne regarding H.R. 142 to Congressman Costello.

1. Q: As a cosponsor of this bill, I support your efforts to extend tax fairness to property owners involved in eminent domain proceedings. How will this initiative correspond with ISTEA, the major transportation legislation passed by the Congress in 1991?

A: The Intermodal Surface Transportation Efficiency Act first passed the House in October of 1991. With all of the transportation improvements planned in this landmark legislation, many citizens across our nation will undoubtedly become involved in eminent domain proceedings. My bill would give these land owners affected by ISTEA land purchases, an opportunity to place the proceeds from the forced sale of their property in a more accessible investment.

2. Q: How does this legislation offer flexibility to property owners whose land has been condemned under eminent domain?

A: H.R. 142 gives property owners the opportunity to invest their gain from the involuntary sale of their property in any real property rather than being limited, as in current law, to similar property. Real property includes land, a home, a stock portfolio or a retirement investment fund.

3. Q: Why did you introduce this bill?

A: The current law was brought to my attention by an elderly farmer, whose land was being seized under eminent domain. When I learned that this farmer must use the proceeds from the sale of his property to purchase more farmland to avoid paying an immediate tax penalty, I decided to introduce legislation to correct what I perceive as an inequity in our tax law. This farmer did not wish to farm in two different counties and was almost ready for retirement. Had my bill been enacted, he could have purchased a retirement home, or any other property, and deferred the tax on his gain.

Mr. HANCOCK. I am very supportive of this. I think we need to look a little deeper into the utilization of eminent domain for purposes other than governmental activities. I think it has been expanded.

Thank you for working with us.

Chairman RANGEL. Thank you, Mr. Costello.

Mr. COSTELLO. Thank you, Mr. Chairman, members of the committee.

[Recess.]

Mr. JACOBS [presiding]. Will the members of the first panel come forward and prepare to give their testimony?

Gentlemen, what I think we will do is take the first witness and when Mr. Smith returns, we can interrupt and take him. In the interests of time, we thought this might be helpful. Justice Phillips, are you here? You may begin your testimony. Is Justice Phillips present?

Chairman RANGEL. Are you accompanied by Mr. Archer?

Judge PHILLIPS. Yes.

Chairman RANGEL. Bill Archer, Congressman from Texas.

Mr. ARCHER. If I may, Mr. Chairman, thank you for granting me this courtesy in introducing——

Mr. JACOBS. You are one of the top people on the committee.

Mr. ARCHER [continuing]. A gentlemen to the committee. I know more Members will be back after the vote. I am sorry they will not be able to hear this introduction, because as complimentary as it may be, it will not do justice to the person I want to introduce, our chief justice of the Texas Supreme Court, Tom Phillips.

Our court some years ago had lost the respect of most of the legal community in the State of Texas and certainly a majority of the people of the State of Texas. A reform effort was undertaken. Justice Tom Phillips was asked to participate in that and ran for the supreme court. He was originally appointed to the supreme court and ran for the supreme court again in subsequent elections. It was really in the spirit of turning the court around, giving it dignity and conveying to the Texans that they once again had a responsible supreme court, that he won.

He is an outstanding individual. I cannot even begin to go through the list of achievements academically and civically in his career.

I do want to say to my friends on the committee that Jake Pickle would have liked to have been here with me today to give him a bipartisan presentation to the committee. However, I think you all know Jake had to be down for John Connally's funeral today and regrets he cannot be here with me. I hope you will listen carefully to his testimony because he is truly one of the fine jurists in this entire country.

Mr. JACOBS. Thank you very much, Mr. Archer. It is always a pleasure to welcome an elderly chief justice to the subcommittee. You have the wisdom of the years, I am sure. Our committee will benefit from the wisdom of Justice Phillips.

STATEMENT OF HON. THOMAS R. PHILLIPS, CHIEF JUSTICE, SUPREME COURT OF TEXAS; AND CHAIR, JOINT TASK FORCE ON JUDICIAL PENSION PLANS, CONFERENCE OF CHIEF JUSTICES; AND CONFERENCE OF STATE COURT ADMINISTRATORS

Judge PHILLIPS. Mr. Chairman, members of the subcommittee, I thank Congressman Archer for that generous introduction. I am Tom Phillips, chief justice of the Supreme Court of Texas. I appear before you on behalf of the Conference of Chief Justices and the Conference of State Court Administrators at the request of the presidents of those two conferences, Chief Justice Robert F. Stephens of Kentucky and Dr. Howard Schwartz of Kansas.

Our conferences are composed of the highest judicial and administrative officers of the 55 State and territorial court systems and the District of Columbia. We appreciate the opportunity to express our views on the effect of nondiscrimination rules on judicial pension plans. My comments are drawn from a report by a joint task force of our two conferences, which I chair on judicial pensions.

You have already received a copy of the report as our written statement, and I ask it be included in the record. I will merely take a few moments to highlight a few points from this report.

First, we believe the application of nondiscrimination rules is inappropriate to judicial pension plans as well as to many other public plans for two reasons. These rules are predicated on the assumption that an employer has structured a pension plan to benefit a few highly paid managers. Most of our plans, however, treat all employees equally, those employees being the judges of a particular jurisdiction.

Second, the rules assume that the designers of the plan are also those who receive the benefits. In our case, judicial pension plans are designed and adopted by an outside body, State legislatures, with the approval of another outside entity, the Governor. Those who will benefit have no direct say in the structure of the plan.

More importantly, we believe the nondiscrimination rules will have serious consequences for the quality of justice in State courts. Therefore, we believe that special treatment by Congress for State judges is both justified and necessary.

First, States have historically used pension plans as an integral part of their efforts to recruit and retain experienced judges. It is fiscally impossible for States to offer salaries that compete with the compensation in the private sector for experienced and able lawyers. Yet experience before going on the bench is the primary means that we have for assuring a well-qualified judiciary. The security offered by a public pension plan is a major financial incentive for qualified attorneys to assume the bench and stay there for the balance of their careers.

Second, from what I have said, it follows that judges typically go on to the bench late in their careers with mandatory retirement ages so that they have only a relatively brief period to accrue retirement benefits. Since the judiciary is always a second career in America, different rules should apply as to vesting and accrual.

Third, reducing State judicial benefits will further widen the discrepancy between State and Federal judicial compensation. Among our entire 50 States, only one judge, the chief justice of the Su-

preme Court of California, gets a salary higher than the $122,912 which Congress has appropriated for a Federal magistrate. Our State trial judges are paid between $61,000 and $100,000, and none of them enjoy the retirement benefits or the job security of a Federal trial judge.

Yet the overwhelming majority, somewhere between 96 and 99.5 percent of cases, are in State courts, including more and more Federal matters for which Congress has extended jurisdiction to State courts.

With our systems therefore more interdependent than ever before, the national interest requires that the best legal talent be attracted to, and remain committed to, the State judiciary.

As the ABA standards on judicial standards state, an attractive retirement program may be instrumental in persuading an experienced attorney to cap his or her legal career by applying for a judgeship. Thus the very characteristics of judicial pension plans that make them so beneficial in the administration of justice are those that place them in jeopardy under the nondiscrimination provisions.

I will be happy to answer any questions. I am pleased to state that Mr. Gareth Cook of the law firm of Vinson & Elkins is sitting right behind me. He has been assisting our task force and can help me answer any technical questions you might have.

[The prepared statement and attachment follow:]

STATEMENT OF CONFERENCE OF CHIEF JUSTICES,
CONFERENCE OF STATE COURT ADMINISTRATORS

REPORT ON
MAINTAINING TAX QUALIFIED STATUS OF
STATE JUDICIAL PENSION PLANS

Submitted by
the Joint Task Force on Judicial Pension Plans
Conference of Chief Justices
Conference of State Court Administrators

June, 1993

Paul J. Liacos
Chief Justice
Supreme Judicial Court of Massachusetts

Carl F. Bianchi
Administrative Director of the Courts
State of Idaho

Malcolm M. Lucas
Chief Justice
Supreme Court of California

Judge Aaron Ment
Chief Court Administrator
State of Connecticut

Thomas R. Phillips
Chief Justice
Supreme Court of Texas

Arthur H. Snowden II
Administrative Director of the Courts
Alaska Court System

Ex-Officio

Robert F. Stephens
Chief Justice
Supreme Court of Kentucky

Howard P. Schwartz, Ph.D.
Judicial Administrator
State of Kansas

JOINT TASK FORCE ON JUDICIAL PENSION PLANS

CONFERENCE OF CHIEF JUSTICES
CONFERENCE OF STATE COURT ADMINISTRATORS

The Conference of Chief Justices and the Conference of State Court Administrators have formed a joint task force to address the threat to our state judicial systems posed by the announced intention of the Internal Revenue Service to apply private sector requirements to state and local pension plans. The following report summarizes our findings and presents a proposed legislative solution to the problem.

The tax-qualified status of judicial retirement systems is in jeopardy because of prospective pending application to those plans of nondiscrimination requirements of the Internal Revenue Code of 1986 ("Code") and regulations that were designed to apply to private-sector plans which are wholly incompatible with long-standing state judicial retirement programs. Because states have used pension plans as an integral part of their efforts to recruit and retain highly qualified judges, disqualification presents a serious threat to the continued strength and effectiveness of our judiciary. Immediate steps must be taken to maintain the tax-qualified status of state judicial pension plans if we are to maintain strong state court systems.

After a careful review of the issue, the Task Force has concluded that Federal legislation will be required to protect the tax-qualified status of state retirement plans for state judges. Although proposed amendments to the IRS regulations will facilitate qualification of most public pension plans, it has been impossible to include state judicial plans in the proposals because of their unique structure. Congressional action, therefore, appears to be the most likely recourse for state courts.

I. BACKGROUND

Under the Code, a tax-qualified retirement plan must not discriminate in favor of highly compensated individuals with respect to coverage or benefits provided by the plan. Historically, and by virtue of public announcement in 1977, the Internal Revenue Service has not applied these rules to public sector (governmental) retirement plans including plans for state judges ("judicial retirement plans"). Following the Tax Reform Act of 1986, however, the Internal Revenue Service has announced in proposed regulations that the nondiscrimination rules would be applied to public sector plans effective in 1996.

Nondiscrimination in coverage and benefits is tested on an employer-wide basis (i.e., considering all employees of an employer). In the case of state plans, for example, the employer presumably is the state. It will be impossible for judicial retirement plans as currently constituted to meet these coverage and benefits rules because the plans (i) cover solely or primarily judges, who may be somewhat more highly compensated than many other state employees, and (ii) often provide benefit levels that replace a greater percentage of active income than do plans covering other state employees.

The consequence of violation of the rules is tax disqualification, resulting in immediate current taxation of judges for vested benefits prior to actual receipt of the benefits, immediate taxation of the increase in vested benefits each year, and, possibly, taxation of income earned on the assets used to fund the plan.

It would be very difficult if not impossible to revise judicial retirement plans to meet the coverage and benefits rules, and to do so would require significant reduction in retirement benefits for judges and severely undermine the state judicial system. It would be fiscally impossible to apply the benefit structure of judicial retirement plans to all state employees.

II. DISCUSSION – APPLICATION OF NONDISCRIMINATION RULES TO JUDICIAL RETIREMENT PLANS

There are cogent reasons why applying the nondiscrimination rules of sections 401(a)(3), 401(a)(4), and 410(b) to judicial retirement plans would be entirely inappropriate.

Divergent Development of Public and Private Sector Plans

Public and private sector plans have developed under completely different sets of legal rules. The Employee Retirement Income Security Act of 1974 ("ERISA") was directed toward private sector retirement plans and does not apply to judicial retirement plans or other governmental, public sector plans. Moreover, in view of the unique circumstances of plans maintained by public employers, the coverage and benefits nondiscrimination rules under the Code have not been applied to public sector plans. Since 1977, the Internal Revenue Service has had a formal policy of not applying these requirements to public sector systems. Accordingly, judicial retirement plans have been developed under state constitutions and laws to meet the particular requirements of the judicial system, as have plans for employees of other branches of government. Legislatures have designed benefit structures appropriate for the covered judges, recognizing that a benefit structure should reflect the nature of duties of covered employees and their special characteristics.

Attracting and Retaining Qualified Judges

The attraction and retention of qualified individuals on the bench has been a major problem throughout the country because of the potential of significantly higher income in the private sector. It is well known that many qualified individuals are leaving the state bench to become federal magistrates because of the higher pay. Many others have eschewed the bench or left the bench due to significant compensation differentials in the private sector. Thus, the provision of adequate retirement benefits as a component of total compensation has been and is expected to be a highly significant factor in attracting qualified individuals to serve as judges and in retaining their service to the judiciary. A retirement plan that provides a satisfactory measure of economic security for the prospective judge and the judge's family is necessary for persons of competence, industry, fairness and integrity to be attracted to the bench. The American Bar Association, in the comment to Standard 1 of its Standards for State Judicial Retirement Plans, concurs:

> Many state judicial systems are not and will not ever be competitive with private practice salaries, and an attractive retirement program may be instrumental in persuading an experienced attorney to cap his legal career by applying for a judgeship.

Unique Circumstances of the Judiciary

In addition, the unique position that judges occupy demands that retirement systems for judges be distinguished from retirement systems for other state government employees and from private sector plans. This reality has been recognized by the federal government in its separate retirement system for federal judges as well as by the states in their own separate systems.

Judges tend to be elected or appointed later in their working careers, with a relatively brief period for accrual of meaningful retirement benefits. In general, only after a significant career in the practice of law may an experienced attorney become a judge, either by appointment or election. Only then may an attorney have demonstrated the exemplary character and fitness needed to serve as a judge and the exceptional ability to discharge effectively the difficult duties associated with adjudicating cases. The American Bar Association, in Standard 3.20 of its Standards for State Judicial Retirement Plans, states:

Recognition should be given to the fact that judges tend to enter judicial service at a later point in their careers than is customary for other state employees. Where a specific period of experience is prerequisite to eligibility for judicial office, this is an especially significant factor and must be considered.

Moreover, in many states judges (but not other state or private sector employees) are subject to mandatory retirement at a specified age, which tends further to shorten the period in which retirement benefits may be earned.

Judges are also subject to limits on their practice of law upon leaving the bench, as described in the Standards for State Judicial Retirement Plans of the American Bar Association. Few other state or private sector employees are subject to similar restrictions on their ability to earn.

Judges are unique in that they are judicial officeholders rather than truly employees. They are elected or appointed for a fixed term, with an authority conferred by law to exercise a portion of the sovereign functions of government. Judges typically have compensation and benefits packages that differ markedly from those of other state employees and in many cases are not entitled to certain benefits available to other employees. Typically, for example, judges are not covered by Social Security or workers' compensation. These factors alone would justify separate treatment for retirement system purposes.

Absence of Salary-Based Discrimination

It is the separateness of the benefit structure for judicial retirement systems that, though based on sound retirement policy and of critical importance to maintaining a qualified judiciary, will cause judicial systems to fail the nondiscrimination in coverage and benefits requirements if they are applied to these systems. These nondiscrimination requirements that prohibit salary-based discrimination in qualified plans for private sector employees, however, should not be applied to judicial retirement plans. The benefit structures under judicial retirement plans are based on job characteristics and important differences between judicial plans and other public sector plans that are not salary- based. Moreover, the same benefit structure is applied consistently within each judicial retirement system; benefits for senior judges, for example, are not discriminatory as against junior judges. In contrast to the private sector, where it is common for owners or other highly compensated decision-makers to decide upon their own retirement benefits, judicial retirement systems are subject to public scrutiny through the legislative process, where state legislatures, not the covered judiciary, make decisions with respect to appropriate retirement benefits. Simply stated, the potential for salary-based discrimination that led to the development of the discrimination tests for private sector plans is not of concern in public sector plans such as plans for the judiciary.

Constitutional Limitations

Public sector retirement systems are constrained by state and federal constitutional limitations, as well as by state statutory and contract law, as to their ability to change the retirement benefits for current judges. The private sector is not subject to these constraints, and may reduce benefits earned after the date of change. Under constitutional impairment of contract rules, most public sector systems cannot reduce benefits -- even on a prospective basis only -- for persons employed before the change. This problem would be particularly acute in the case of diminution of the compensation (including retirement benefits) of a judge during his or her term of office.

Accordingly, difficult litigation would be likely were retirement benefits for judges to be simply cut back to comply with the federal tax rules. In effect, application of the nondiscrimination rules to judicial retirement plans may force the states to attempt to resort to a pay-as-you-go system.

Prohibitive Cost of Compliance

The cost to the states to comply or attempt to comply with the highly technical, complex nondiscrimination rules and related tests would be enormous. States do not have the technical expertise or administrative systems to comply. It would, moreover, be prohibitively expensive and inappropriate to apply the benefit levels for judges to all state employees.

Comparison to Federal Judges

Federal judges benefit from more favorable compensation and retirement systems than do state judges. Federal judges are covered by Social Security and are entitled to retirement benefits that are typically greater than state retirement benefits for judges. Most importantly, the life tenure enjoyed by federal judges has a substantial impact on realized retirement security.

A further widening of the gap between benefits accorded to judges under the federal system and judges under state systems would be inappropriate. The American Bar Association, in its Standards for Judicial Compensation, concurs:

Since federal trial judges are comparable to state trial judges as to their duties and level of responsibility and generally are drawn from the same or a similar supply pool, state judges should be compensated on a level commensurate with that of federal judges, who enjoy the added benefit of life tenure. Only in this way can the state bench attract the best qualified lawyers.

III. PROPOSED REMEDIAL CHANGES IN THE CODE

Although it has been hoped that the problem facing judicial retirement plans might be addressed in regulations or other authority issued by the Internal Revenue Service, it now appears that the only feasible approach would be remedial changes in the Code. Attachment I to this paper suggests specific legislative language that would remedy the most significant problems facing qualified judicial retirement plans. The changes proposed in Attachment I are discussed, item-by-item, below.

1. Section 401(a)(4)

Section 401(a)(4) prohibits discrimination in contributions and benefits, tested by virtue of section 414(b) and (c) as to all employees of an employer. Under proposed amendments to Treasury Regulation § 1.401-4, judicial retirement plans will be treated as satisfying section 401(a)(4) only through 1995 and will be required to comply with section 401(a)(4) thereafter. Since public retirement systems consist of many separate plans covering separate segments of public employees, judicial retirement plans will not meet section 401(a)(4) and thus need to be exempted from its application. This is best accomplished by adding to paragraph (5) (special rules relating to nondiscrimination requirements) a new subparagraph (F) deeming judicial retirement plans to comply with section 401(a)(4).

This provision would be effective for years beginning on or after date of enactment. Judicial retirement plans would be treated as in compliance with section 401(a)(4) for years beginning before the date of enactment.

2. Section 401(a)(26)

Section 401(a)(26) generally provides that a qualified plan must cover at least the lesser of 50 employees or 40% of all employees of the employer. Although it would be unusual for a judicial retirement plan to cover less than 50 judges, that possibility is dealt with by adding a new subparagraph (H) making section 401(a)(26) inapplicable to judicial retirement plans. A conforming change would redesignate existing subparagraphs (H) and (I) as subparagraphs (I) and (J).

This provision would be effective for years beginning on or after date of enactment. Judicial retirement plans would be treated as in compliance with section 401(a)(26) for years beginning before the date of enactment.

3. Section 410(b) and Section 401(a)(3)

The nondiscrimination in coverage rules are set forth in section 401(a)(3) and section 410(b) and are applied to all employees of an employer by virtue of section 414(b) and (c). Under proposed amendments to Treasury Regulation § 1.410(b), judicial retirement plans will be treated as satisfying section 410(b) and 401(a)(3) only through 1995 and will be required to comply with these provisions thereafter. Although governmental plans are to be tested under pre-ERISA coverage rules, judicial retirement plans will not meet the coverage rules. A new paragraph (3) should be added to section 410(c) (application of standards to certain plans) that would deem the coverage rules to be met by judicial retirement plans. Conforming changes would be made in paragraphs (1) and (2) of section 410(c).

These provisions would be effective for years beginning on or after date of enactment. Judicial retirement plans would be treated as in compliance with section 410 for years beginning before the date of enactment.

4. Section 414

A definition of "judicial retirement plan" would be added to section 414 that would apply for purposes of sections 401, 410, and 415.

This provision would be effective for years beginning on or after date of enactment.

5. Section 415

Present law in section 415 imposes limits on contributions and benefits under qualified plans. Because of the unique problems faced by governmental plans, the Revenue Bill of 1992, which was passed by Congress before being vetoed by the President, provided special rules for governmental plans, including judicial retirement plans. The changes that would have been made by the Revenue Bill of 1992 to section 415 as applied to governmental plans remain pertinent and needed. Such changes included (1) compensation for section 415 purposes includes employer contributions to 401(k) plans, cafeteria plans, and 457 plans under a salary reduction arrangement; (2) the 100% of compensation limit does not apply; and (3) the defined benefit pension plan limitation does not apply to certain disability and survivor benefits. With reference to the 100% of compensation limit, it is noted that many judicial plans base retirement benefits of a retired judge on the salary of active judges, so that the 100% of compensation limit on the amount of a retired judge's pension may in some cases become inappropriate during periods of high inflation.

These provisions would be effective for years beginning on or after date of enactment. Governmental plans would be treated as in compliance with section 415 for years beginning before the date of enactment.

ATTACHMENT I

PROPOSED CHANGES TO INTERNAL REVENUE CODE OF 1986
RELATING TO QUALIFIED JUDICIAL RETIREMENT PLANS

1. Treatment of Judicial Retirement Plans Under Section 401(a) Nondiscrimination Requirements

(a) NONDISCRIMINATION REQUIREMENTS. -- Paragraph (5) of subsection (a) of section 401 (regarding requirements for qualification) is amended by adding immediately after subparagraph (E) thereof the following new subparagraph:

"(F) JUDICIAL RETIREMENT PLANS. -- A judicial retirement plan (within the meaning of section 414(u)) shall not be considered discriminatory within the meaning of paragraph (4)."

(b) ADDITIONAL PARTICIPATION REQUIREMENTS. -- Paragraph (26) of subsection (a) of section 401 is amended by adding immediately after subparagraph (G) thereof the following new subparagraph:

"(H) JUDICIAL RETIREMENT PLANS. -- This paragraph shall not apply to a judicial retirement plan (within the meaning of section 414(u))."

(c) CONFORMING AMENDMENT. -- Paragraph (26) of subsection (a) of section 401 is amended by redesignating subparagraphs (H) and (I) thereof as subparagraphs (I) and (J), respectively.

(d) EFFECTIVE DATE. --

(1) IN GENERAL. -- The amendments made by subsections (a), (b), and (c) shall apply to taxable years beginning on or after the date of the enactment of this Act.

(2) TREATMENT FOR YEARS BEGINNING BEFORE DATE OF ENACTMENT. -- In the case of a judicial retirement plan (as defined in section 414(u) of the Internal Revenue Code of 1986), such plan shall be treated as satisfying the requirements of sections 401(a)(4) and 401(a)(26) of such Code for all taxable years beginning before the date of the enactment of this Act.

2. Application of Section 410 Participation and Coverage Standards to Judicial Retirement Plans

(a) APPLICATION OF STANDARDS. --

(1) Paragraph (1) of subsection (c) of section 410 (relating to minimum participation and coverage) is amended by inserting "and paragraph (3)" after "(other than paragraph (2)" in the first line thereof.

(2) Paragraph (2) of subsection (c) of section 410 is amended by striking "A" at the beginning of the first line thereof and inserting "Except as provided in paragraph (3), a" therefor.

(3) Subsection (c) of section 410 is amended by adding immediately after paragraph (2) thereof the following new paragraph:

"(3) A judicial retirement plan (within the meaning of section 414(u)) shall be deemed to meet the requirements of this section."

(b) EFFECTIVE DATE. --

(1) IN GENERAL. -- The amendments made by subsection (a) shall apply to taxable years beginning on or after the date of enactment of this Act.

(2) TREATMENT FOR YEARS BEGINNING BEFORE DATE OF ENACTMENT. -- In the case of a judicial retirement plan (as defined in section 414(u) of the Internal Revenue Code of 1986), such plan shall be treated as satisfying the requirements of section 410 of such Code for all taxable years beginning before the date of enactment of this Act.

3. Judicial Retirement Plan Defined

(a) DEFINITION OF JUDICIAL RETIREMENT PLAN. -- Section 414 is amended by adding immediately after subsection (t) thereof the following new subsection:

"(u) JUDICIAL RETIREMENT PLAN. -- For purposes of sections 401, 410, and 415, the term 'judicial retirement plan' means a plan or any portion of a plan established and maintained for its employees by the government of any State or political subdivision thereof, or by any agency or instrumentality of the foregoing, and which provides for participation, coverage, contributions, or benefits which are primarily for, by or on behalf of judges or justices appointed or elected in accordance with the constitution and laws of such State, political subdivision or agency or instrumentality."

(b) EFFECTIVE DATE. -- The amendment made by subsection (a) shall apply to taxable years beginning on or after the date of enactment of this Act.

4. Treatment of Governmental Plans Under Section 415

(a) EXEMPTION FOR SURVIVOR AND DISABILITY BENEFITS. -- Paragraph (2) of section 415(b) is amended by adding at the end thereof the following new subparagraph:

"(I) EXEMPTION FOR SURVIVOR AND DISABILITY BENEFITS PROVIDED UNDER GOVERNMENTAL PLANS. -- Subparagraph (B) of paragraph (1), subparagraph (C) of this paragraph, and paragraph (5) shall not apply to--

(i) income received from a governmental plan (as defined in section 414(d)) as a pension, annuity, or similar allowance as the result of the recipient becoming disabled by reason of personal injuries or sickness, or

(ii) amounts received from a governmental plan by the beneficiaries, survivors, or the estate of an employee as the result of the death of the employee."

(b) COMPENSATION LIMIT. -- Subsection (b) of section 415 is amended by adding immediately after paragraph (10) the following new paragraph:

"(11) SPECIAL LIMITATION RULE FOR GOVERNMENTAL PLANS. -- In the case of a governmental plan (as defined in section 414(d)), subparagraph (B) of paragraph (1) shall not apply."

(c) DEFINITION OF COMPENSATION. -- Subsection (k) of section 415 (regarding limitations on benefits and contributions under qualified plans) is amended by adding immediately after paragraph (2) thereof the following new paragraph:

"(3) DEFINITION OF COMPENSATION FOR GOVERNMENTAL PLANS. -- For purposes of this section, in the case of a governmental plan (as defined in section 414(d)), the term 'compensation' includes, in addition to the amount described in subsection (c)(3) --

(A) any elective deferral (as defined in section 402(g)(3)), and

(B) any amount which is contributed by the employer at the election of the employee and which is not includible in the gross income of an employee under section 125 or section 457."

(d) EFFECTIVE DATE. --

(1) IN GENERAL. -- The amendments made by subsections (a), (b), and (c) shall apply to taxable years beginning on or after the date of enactment of this Act.

(2) TREATMENT FOR YEARS BEGINNING BEFORE DATE OF ENACTMENT. -- In the case of a governmental plan (as defined in section 414(d) of the Internal Revenue Code of 1986), such plan shall be treated as satisfying the requirements of section 415 of such Code for all taxable years beginning before the date of enactment of this Act.

Chairman RANGEL [presiding]. Thank you. You stated preferential treatment should be given to judicial pension plans. Could you share with us on a general policy level how these judicial pension plans differ from benefit plans offered by large private employers to their highly compensated employees? Is there a major difference?

Judge PHILLIPS. Basically the judicial pension plans—I don't know enough about how highly compensated employees work in the private sector. Generally, the difference between our plans and those that a normal public employee would have is that the vesting time comes a little sooner, somewhere between 10 and 15 years, to take account of the 10 or 15 years average service of an optimum judge; and, therefore, the yearly rate that is contributed is somewhat higher than the average State employee who is making an entire career in State government would have.

Chairman RANGEL. You are distinguishing between two public servants. I am asking have you compared how judges are treated in their pension plans with how private employers who have highly paid employees are treated in other pension benefit plans?

Judge PHILLIPS. We have not made a direct comparison except to say that most of our judges who come on the bench at 50 would take a considerable pay cut if they have been doing well in private service. Obviously, I think their benefits would be less than they would have been in a corresponding private plan had they stayed in private practice during their most remunerative years.

Chairman RANGEL. OK.

Thank you so much, Judge Phillips.

I am going to ask unanimous consent to allow Congressman Nick Smith of Michigan to testify at this time. The panel can stay where you are.

Congressman Smith, you may take that chair.

STATEMENT OF HON. NICK SMITH, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MICHIGAN

Mr. SMITH. Mr. Chairman, thank you very much.

I am here today to ask that you consider a bill that I have introduced. I have 76 cosponsors now. It is H.R. 539. I am suggesting today that we amend the provisions of 539 to include indexing of capital gains income and to index interest income for tax purposes.

The Joint Committee on Taxation has reviewed the bill, and they have stated there will be a $4 billion surplus in the first 5 years. Modifying to the bill as introduced, by doing away with the retroactivity of the adjustment to the alternative minimum tax, would add another $14 billion to the bill. The $18 billion surplus would allow the indexing of both interest income and the indexing of capital gains.

It seems to me that if we are going to encourage savings and investment, and right now we have taken out the ITC provisions the President suggested for business; the rumor is the Senate is considering taking that out for small business. How do we put U.S. business on the same kind of playing field as the rest of the world? We must encourage our companies and businesses to expand, to buy the new machinery and equipment that is going to allow us to be more competitive?

It is easy to believe that we should allow a business to deduct what they pay for new machinery and equipment as a business expense; but we do not allow that company to deduct as a business expense the money they are paying out for equipment and machinery. We don't because we don't consider in the depreciation schedule the impact of inflation and the time value of money.

In other words, as this special subcommittee I am sure is aware, if the interest rate were 6 percent and if a business were depreciating part of today's cost for that equipment and machinery 15 years from now, we only allow them to depreciate in terms of today's dollars only about half of the real cost of that equipment.

But I think the bottom line is, if we are going to put our business and companies on the same kind of equal tax treatment as the rest of the world to make these capital purchases to be much less expensive because of their favorable tax treatment, then it is reasonable to consider some ways to make that effort by those businesses a little cheaper.

I will be 60 years old next year. I've talked with businessmen who are my age, and they say well, we are just going to hang on; we are not going to take the risk and make the investment because everything is too much up in the air right now.

Again, on interest income, if we say only that interest income that exceeds inflation is real increase in wealth in terms of what we tax that person, we are going to encourage savings. Right now, the United States, compared to the rest of the G–7 countries of the rest of the world that we compete with, has the lowest savings rate.

We look at Japan that saves 20 percent out of every disposable income dollar; Korea is up to 35 percent. In this country, it is about 2 percent we save. Somehow, we have to encourage more savings if we expect that capital to be more readily available to business.

The second goal is to encourage business to invest in that capital machinery and equipment that is going to hopefully make them more efficient, more productive, and ultimately more competitive.

[The prepared statement follows:]

TESTIMONY OF REP. NICK SMITH
BEFORE THE
WAYS AND MEANS SUBCOMMITTEE ON SELECT REVENUE MEASURES

JUNE 17, 1993

MR. CHAIRMAN AND MEMBERS OF THE WAYS AND MEANS SUBCOMMITTEE ON SELECT REVENUE MEASURES, I AM HERE TODAY TO ASK THAT YOU CONSIDER THE INVESTMENT TAX INCENTIVE ACT, H.R. 539, AMENDED TO ALLOW FOR INDEXING CAPITAL GAINS FOR INFLATION AND ANNUAL INTEREST INCOME TO BE TAXED ONLY FOR THE RETURN ABOVE THE CURRENT RATE OF INFLATION. I RECOMMEND THESE PROVISIONS FOR INCLUSION IN THE TAX BILL YOU WILL BE MARKING UP SHORTLY.

H.R. 539, MR. CHAIRMAN, ACCORDING TO THE REVENUE ESTIMATE PREPARED BY THE JOINT COMMITTEE ON TAXATION, WOULD CREATE SAVINGS OF ALMOST 4 BILLION DOLLARS OVER THE NEXT FIVE YEARS. THE CHANGE TO DO AWAY WITH THE ALTERNATIVE MINIMUM TAX PROVISIONS IN H.R. 539 WILL RESULT IN AN ADDITIONAL $10 BILLION OF REVENUE OVER THE NEXT FIVE YEARS. THAT AMOUNT WOULD PAY FOR TAXING INTEREST INCOME AND CAPITAL GAINS ONLY TO THE EXTENT THEY EXCEED INFLATION.

IF WE ARE GOING TO ENCOURAGE SAVINGS AND INVESTMENT, THEN IT IS REASONABLE TO HAVE A TAX POLICY THAT ONLY TAXES REAL INCOME, OR THAT AMOUNT OF INCREASED VALUE IN EXCESS OF INFLATION. IF WE ARE GOING TO ENCOURAGE BUSINESSES TO INVEST IN MACHINERY AND EQUIPMENT TO INCREASE THEIR PRODUCTIVITY AND COMPETITIVENESS, IT IS REASONABLE TO ALLOW THESE BUSINESSES TO CONSIDER THESE PURCHASES A BUSINESS EXPENSE. IN OTHER WORDS, ALLOW BUSINESS TO DEDUCT THE COST OF EQUIPMENT IN DETERMINING TAXABLE INCOME.

MY PROPOSAL, H.R. 539, WAS ENDORSED BY TWO OF THE LEADING BUSINESS ORGANIZATIONS IN AMERICA: THE U.S. CHAMBER OF COMMERCE AND THE NATIONAL FEDERATION OF INDEPENDENT BUSINESS. THE ADDITIONAL CHANGES TO INDEX CAPITAL GAINS AND THE TREATMENT OF INTEREST INCOME FURTHER IMPROVE THE BILL.

THESE GROUPS UNDERSTAND THE LONG-TERM BENEFITS OF INDEXING DEPRECIATION WILL SPUR ECONOMIC GROWTH, SPUR INVESTMENT IN EQUIPMENT AND MACHINERY, AND HELP CREATE JOBS. INDEXING CAPITAL GAINS AND ALLOWING ANNUAL INTEREST INCOME TO BE TAXED ONLY ON THE AMOUNT ABOVE INFLATION WOULD ENCOURAGE SAVINGS, INVESTMENT, AND STRENGTHEN THE ECONOMY.

MOVING TO A SYSTEM THAT IS THE EQUIVALENT OF EXPENSING FOR MACHINERY AND EQUIPMENT IS SOMETHING MOST ECONOMISTS ENDORSE READILY.

UNDER THIS PROPOSAL, BUSINESSES WOULD BE ALLOWED TO INDEX DEPRECIATION FOR INFLATION. SIMILAR TO THE PRESIDENT'S PROPOSAL, THIS PROPOSAL WOULD ENCOURAGE BUSINESSES TO PURCHASE NEW EQUIPMENT BY HAVING A TAX POLICY THAT REDUCES THE COST OF THAT EQUIPMENT. MOST OF OUR COMPETITORS IN THE WORLD HAVE A MUCH MORE FAVORABLE TAX POLICY TO ENCOURAGE BUSINESS INVESTMENT.

BECAUSE IT IS REVENUE POSITIVE OVER THE FIRST FIVE YEARS, IT MEETS THE 1990 BUDGET ACT'S PAYGO PROVISIONS.

THE REVENUE OFFSET FOR THIS OPTIONAL METHOD OF DEPRECIATION UNDER H.R. 539 IS THE REDUCTION OF THE 200% DECLINING BALANCE METHOD FOR DETERMINING FIRST YEAR DEPRECIATION TO A RATE OF 150%.

IT IS IMPORTANT TO NOTE THAT THE DECISION TO USE THE ITI IS OPTIONAL FOR ANY BUSINESS. EXTRA DEPRECIATION IN THE OUT YEARS IS THE SIGNIFICANT ADVANTAGE OF THIS CHOICE.

ONE IMPORTANT POINT TO CONSIDER WHEN REVIEWING THIS BILL IS THAT TAXES BE DRAMATICALLY INCREASED UNDER THE CURRENT RECONCILIATION BILL. THE ADDED COST OF THE ENERGY TAX AND INCREASED CORPORATE TAX RATE, AS WELL AS ELIMINATING THE PRESIDENT'S MODEST INVESTMENT TAX CREDIT WILL RESULT IN A CORPORATE INCOME TAX THAT WILL INHIBIT ECONOMIC GROWTH.

WHILE THE EXPENSING PROVISION IN THE HOUSE RECONCILIATION BILL WOULD HELP SMALL BUSINESSES SOME, OUR LARGEST AND MOST INTERNATIONALLY COMPETITIVE MANUFACTURERS AND EXPORTERS ARE DISADVANTAGED. MY PROPOSAL WOULD ALLEVIATE SOME OF THIS ECONOMIC HARM AND ACTUALLY REDUCE THE DEFICIT.

MR. CHAIRMAN, IT IS IMPORTANT TO NOTE THAT OVER THE LAST 10 YEARS, THE UNITED STATES HAS TRAILED ALL OF OUR INDUSTRIALIZED COMPETITORS IN CAPITAL INVESTMENT PER WORKER EXCEPT FOR GREAT BRITAIN. A RECENT STUDY BY DRS. BRADFORD DE LONG AND LAWRENCE SUMMERS, FORMER TREASURY UNDER SECRETARY FOR INTERNATIONAL AFFAIRS, FOUND THAT EACH ONE PERCENT OF GROSS DOMESTIC PRODUCT (GDP) INVESTED IN EQUIPMENT CAUSES GDP TO INCREASE BY ONE-THIRD OF A PERCENTAGE POINT PER YEAR. IN EFFECT, IT MEANS AN INCREASE IN EQUIPMENT INVESTMENT OF 3% WOULD RESULT IN GDP GROWTH BY OVER 1%, OR 60 BILLION DOLLARS!

A STUDY DONE THIS YEAR BY THE AMERICAN COUNCIL ON CAPITAL FORMATION FOUND THAT U.S. CORPORATE TAX DEPRECIATION RULES PUT US AT A STRONG DISADVANTAGE TO OUR COMPETITORS. WE TRAIL THE INDUSTRIALIZED WORLD IN THE PRESENT VALUE OF EQUIPMENT COMPARED TO COST FOR FACTORY ROBOTS; FOR CRANK SHAFTS; AND FOR CONTINUOUS CASTING FOR STEEL PRODUCTION. WE MANAGED TO TIE TAIWAN FOR ENGINE BLOCKS; WE SLIDE BY JAPAN FOR SEMICONDUCTORS; AND WE HOLD OUR OWN ON TELEPHONE SWITCHING EQUIPMENT. WE TRAIL EVERY NATION ON POLLUTION CONTROL DEVICES -- BY AS MUCH AS 50% ON SCRUBBERS.

MR. CHAIRMAN, AND MEMBERS OF THE SUBCOMMITTEE. WE HAVE A CHANCE TO LOWER THE COST OF EQUIPMENT FOR BUSINESS BY ADJUSTING DEPRECIATION FOR INFLATION AND THE TIME VALUE OF MONEY. BY DOING SO, WE WILL CREATE JOBS AND PROMOTE ECONOMIC GROWTH. WE ALSO HAVE THE CHANCE TO INDEX CAPITAL GAINS FOR INFLATION AND REVISE THE TREATMENT OF INTEREST INCOME TO ONLY TAX THAT AMOUNT ABOVE INFLATION. THE NET EFFECT WILL BE A MORE COMPETITIVE UNITED STATES OF AMERICA.

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Chairman RANGEL. Thank you. That estimate of $14 billion over the period of time, where did it come from?

Mr. SMITH. The Joint Tax Committee estimated the dollar savings for the first 5 years is going to be $4 billion. If I take out the retroactivity of the ACE adjustment, then it would go up to $14 billion. The revenue comes from an optional method of depreciation.

The optional method requires that instead of a 200 percent declining balance method the first year, you would just be allowed 150 percent; going from 200 percent to 150 percent is what results in the $14 billion excess over the first 5 years.

Chairman RANGEL. This is a tremendous amount of money. I am working on something similar to this myself. One of the policy benefits that we face, however, is that this is perceived as another incentive to the wealthy; and it does not bring balance to a progressive tax system or all of the benefits that the poor and middle income would receive as a result of a trickle down.

How do you respond to that?

Mr. SMITH. I think somehow if we expect our businesses to compete with other businesses in the world, we have to be somewhat similar in terms of our tax policy to encourage competitiveness.

Also, I would like to point out again that this—the provision of indexing depreciation results in a $14 billion increase in revenues in the first 5 years that can be used for what I am suggesting—indexing capital gains and indexing interest income, or simply going to reduce the deficit.

Chairman RANGEL. I understand that. But I am saying as a matter of policy, I think you would agree that those people who receive the immediate benefit would be those people who would be in the high-income category, wouldn't they?

Mr. SMITH. I don't mean to be too theoretical. Companies are a name on a sheet of paper and a corporation is a form attorneys can put together. Whatever the cost to the business is, they, to the best extent possible, are going to pass it on to the customers of that product.

So a business, to the extent they pass on additional costs to the end consumer of that product, is going to pass that cost on, depending upon what the product is, and is going to depend on the progressivity of the ultimate results.

Chairman RANGEL. Wouldn't the results be——

Mr. SMITH. I sound like I am lecturing here. I don't mean to do that.

Chairman RANGEL. That is all right. Wouldn't the results be that by removing the inflationary value of the stock, that it would encourage more people to expose their stock to a lower tax and generate—that is how you generate, really, your income, because as it is now, people that find their stock inflated are not prone to expose themselves to the 28 percent for the inflated value; isn't that true?

Mr. SMITH. I participated in a lot of discussions on how we might change the IRA procedures; how we might change the additional deductibility to encourage savings. This is another way that would encourage savings by taxing real increase in revenue from any particular source.

Chairman RANGEL. I am really not making the point as clear as I would like.

Mr. SMITH. I am sure I am not answering.

Chairman RANGEL. I was trying to see whether or not you could couple this suggestion with providing some type of immediate relief with parts of that $500 billion, or the $14 billion additional, without retroactivity with other segments of the—of our population who would not enjoy the benefits of this preferential or favorable treatment on capital gains.

Mr. SMITH. It is possible to increase the positive effect to the lower income that maybe we consider putting caps on the amount of interest that is subject to this provision; but it seems to me, we are increasing the taxes on business in the proposal that is moving forward. Are we sure that we are not overimposing taxes that are going to discourage expansion of business and jobs?

Chairman RANGEL. Thank you.

Do any members have questions?

Mr. Camp.

Mr. CAMP. Thank you, Mr. Chairman. I just want to state to my colleague from Michigan that encouraging investment and savings is certainly an admirable goal. I want to compliment you for your efforts.

Mr. SMITH. Thank you.

Mr. Chairman, members of the committee, thank you for your time.

Chairman RANGEL. Congressman Brewster? I yield to you for the purpose of introducing a member of the panel.

Mr. BREWSTER. Thank you, Mr. Chairman. It is an honor to be here today. I have a written statement for the record.

[The prepared statement follows:]

TESTIMONY OF CONGRESSMAN BILL BREWSTER BEFORE THE COMMITTEE ON WAYS AND MEANS SUBCOMMITTEE ON SELECT REVENUE MEASURES JUNE 17, 1993

Mr. Chairman and members of the Subcommittee, I am pleased to appear before you today in support of H.R. 1981, the Qualified Football Coaches Plan Technical Corrections Act of 1993, which I introduced and which eight of my colleagues on the Committee on Ways and Means have co-sponsored.

H.R. 1981 would clarify the tax treatment of a qualified football coaches plan. It is specifically intended to address a problem that has arisen with respect to the American Football Coaches Retirement Trust.

H.R. 1981 would make a technical correction to a 1987 amendment to the Employee Retirement Income Security Act. The 1987 amendment, section 136 of P.L. 100-202, was expressly designed to permit the American Football Coaches Association to establish for its members a tax-qualified multi-employer plan with a section 401(k) feature A technical correction to that legislation is now needed because the I.R.S. has taken the position that the 1987 amendment was placed in the wrong title of ERISA.

Let me briefly relate the pertinent background. In 1987, Congress amended Title 1 of ERISA to permit a qualified football coaches plan to be treated as a multi-employer plan. The 1987 amendment, which had 151 co-sponsors in the House and 51 co-sponsors in the Senate, was specifically crafted to apply only to the American Football Coaches Association, which represents over 5,000 head coaches and assistant coaches at our colleges and universities. The 1987 amendment authorized the association to establish and maintain a defined contribution plan, which "notwithstanding section 401(k)(4)(B) of [the Internal Revenue Code], may include a qualified cash and deferred arrangement." In reliance on this 1987 amendment to Title 1 of ERISA, the American Football Coaches Association organized a trust which since 1988 has

offered a section 401(k) retirement plan to the football coaches. The I.R.S. issued several determination letters to the American Football Coaches Association. Each of the letters confirmed that the section 401(k) plan sponsored by the Association was a qualified retirement plan. The first letter was issued on June 30, 1988, with two subsequent favorable determination letters issued on July 3, 1989 and April 9, 1991.

However, section 9343(a) of the Omnibus Budget Reconciliation Act of 1987 ("OBRA"), which was enacted into law on the same date in 1987 as P.L. 199-202, provides that "except to the extent specifically provided in the Internal Revenue Code of 1986 or as determined by the Secretary of the Treasury, titles 1 and 4 of the Employee Retirement Income Security Act of 1974 are not applicable in interpreting such code." As I previously mentioned, the 1987 amendment authorizing the section 401(k) plan for football coaches was placed in Title 1 of ERISA. Section 9343(a) of OBRA thus is potentially in conflict with section 136 of P.L. 100-202.

Section 9343(a) of OBRA was enacted to override a Tax Court case, Calfee, Halter, Griswold v. Commissioner, 88 TC 641 (1987), which had allowed retirement plan sponsors to remove contributions they had made to pension plans that had been set up several years earlier. The I.R.S. has taken the position that section 9343(a) of OBRA also overrides the specific amendment made by Congress in 1987 authorizing the association's section 401(k) plan. Therefore, in 1992, the I.R.S. moved to revoke the favorable determination letters it had issued. In March of 1993 the I.R.S. officially forwarded to the Association a technical advice memorandum which determined that the American Football Coaches Association's section 401(k) retirement plan arrangement was in violation of Code section 401(k)(4)(B)(ii). The I.R.S. revoked the plan's qualified status prospectively, which gave the association the opportunity to approach Congress for a legislative correction. But unless

Congress acts now, the plan will have to terminate and distribute its assets by December 31, 1993.

There is no doubt that congress intended to authorize the association's section 401(k) retirement arrangement. Let me refer you briefly to the colloquy that took place in the Senate on the 1987 amendment. Senator Symms, in a December 11, 1987 colloquy, stated that the 1987 ERISA amendment was specifically designed to allow the American Football Coaches Association, or AFCA, to establish a pension plan under section 401(k). As Senator Symms stated:

> This amendment adds AFCA to the list of organizations allowed to use section 401(k) ... [a]nd it provides coaches the use of a 401(k) pension plan through their professional association, the AFCA.

The American Football Coaches Association therefore is seeking action by Congress to preserve the qualified status of its section 401(k) retirement plan arrangement. I recognize the coaches' need for a retirement plan that is fully vested and fully portable. I was glad to introduce legislation to affirm the 1987 decision by Congress to authorize the coaches' section 401(k) plan. By making the 1987 amendment effective for purposes of Title 2, as well as Title 1 of ERISA, H.R. 1981 will make a simple technical correction to address the concern raised by the I.R.S. that section 9343(a) of OBRA overrides the legislation passed by Congress allowing the association to establish and maintain a qualified plan for its members.

I ask that all my colleagues work with me in seeing that H.R. 1981 is enacted.

Mr. BREWSTER. I would like to make a few oral comments.

In 1987, Congress passed an amendment to ERISA that allowed the American Football Coaches Association to set up a 401(k) plan. Now, because of a technicality in the law and the title, the IRS is inclined to disallow that and has given them until the end of this year to correct it in the title. H.R. 1981 would make that correction. I will keep my comments there, but I would like to introduce a real expert, a real gentleman to talk about this.

Mr. Charlie McClendon grew up in Arkansas, went to college in Kentucky, but more than that, has been the head football coach at LSU for 18 years; his total coaching experience there is 27 years. Not many coaches stay anywhere that long anymore. He must have done something right. He is executive director of the American Football Coaches Association. We would like to hear his testimony on this issue.

STATEMENT OF CHARLES McCLENDON, EXECUTIVE DIRECTOR, AMERICAN FOOTBALL COACHES ASSOCIATION

Mr. MCCLENDON. Thank you, Mr. Brewster. You have to answer to a lot of names at LSU if you do lose a football game.

I am executive director of the American Football Coaches Association. Prior to becoming executive director of the AFCA, I served as the head coach of Louisiana State University football team for 13 years. The AFCA represents more than 5,000 football coaches and assistant coaches at 687 of our Nation's colleges and universities throughout the United States.

I welcome this opportunity to appear before the subcommittee to discuss H.R. 1981, the Qualified Football Coaches Plan Technical Corrections Act of 1993. We are enormously grateful to Mr. Brewster, along with the other colleagues on the Ways and Means Committee, Mr. McCrery, Mr. Camp, Mr. McDermott, Mr. Bunning, Mr. Jacobs, Mr. Crane, Mr. Sundquist, and Mr. Thomas for introducing this important legislation.

H.R. 1981 would make a technical correction to legislation enacted by the Congress in 1987 that was specifically designed to allow football coaches to establish a fully vested and fully portable retirement plan. I will describe to you the problem that has arisen and explain why we believe H.R. 1981 should be enacted to correct that problem and answer any questions you may have.

In 1987 the American Football Coaches Association approached Congress and asked for a specific and very limited tax law change that would allow college football coaches the benefit of a section 401(k) plan established through the American Football Coaches Association.

We indicated that most coaches and assistant coaches, unlike my experience, have short tenures at particular educational institutions. For instance, the average tenure of a coach or assistant coach at a small educational institution is under 3 years. Therefore, it is extremely difficult for the coaches to become vested in their college or university retirement plan. College coaches need retirement security regardless of their job tenure uncertainties.

We asked Congress for legislative solutions that specifically would allow us to form a qualified cash or deferred retirement plan

so that college coaches could contribute to a retirement plan that would be fully portable and fully vested.

We were most gratified with the response we received from Congress in 1987. We had 151 House Members and 34 Senate Members cosponsor legislation that amended the Employment Retirement Income Security Act of 1974.

The amendment specifically permitted the American Football Coaches Association to establish a tax-qualified multiemployer plan with a section 401(k) feature. That amendment to ERISA was enacted on December 22, 1987, as part of the Public Law 100–202.

Based on that 1987 ERISA amendment, the association established a retirement plan called the American Football Coaches Retirement Trust. We took all the necessary procedures, steps to obtain a favorable determination level from the IRS. That trust constituted a qualified retirement plan. We received our first favorable determination letter on June 10, 1988, in which the IRS confirmed the plan met the requirement of section 401(k).

Additional favorable determination letters were also issued by the IRS on July 3, 1989, and April 9, 1991. And then in 1992, after the plan had been in operation for almost 4 years, the IRS began to revisit the issue. On March 22, 1993, almost 5 years after our original favorable determination, the IRS sent us a technical advice memorandum holding the American Football Coaches Retirement Trust failed to satisfy the requirement of section 401(k).

The IRS has given us until December 31, 1993, to liquidate the plan and make distribution to plan members. If we are forced to liquidate the plan, we will forfeit the significant expenses we have incurred to establish and maintain our plan, and coaches will be back to where they were before 1987 with no vehicle to ensure they had a retirement plan.

The IRS has taken the position that our plan does not qualify as a result of technical provisions enacted in 1987. That provision, which clearly no one, including the IRS, contemplated, would apply to our plan. That is section 9343(a) of the Omnibus Budget Reconciliation Act of 1987. It was enacted into law on December 22, 1987, the very same day that Public Law 100–202—the law that amended ERISA to authorize our plan—was enacted.

Section 9343(a) and provisions of titles I and IV of ERISA are not applicable when interpreting the Internal Revenue Code. The ERISA amendment that Congress gave us in 1987 was placed in title I of ERISA. Therefore, as strictly a technical matter, the IRS concluded the 1987 ERISA amendment does not do the one thing it was intended to do, authorize our American Football Coaches Association to sponsor a fully vested and fully affordable qualified retirement plan for college football coaches.

Although there is no doubt that Congress intended to authorize that section 401(k) retirement plan, the IRS has revoked our tax-exempt status. Consequently, we are faced with the situation that we will have to dissolve our plan, unless Congress acts this year.

H.R. 1981 would correct the technical objections raised by the IRS and allow us to continue our section 401(k) plan. In short, H.R. 1981 should fulfill the promise of the 1987 legislation.

In closing, I want to stress to the members of the subcommittee that the need of college football coaches for this retirement savings

arrangement remains great. Head and assistant coaches are still faced with short tenures at colleges and universities, and they have little chance to qualify for other retirement plans. Therefore, your favorable action on H.R. 1981 would fulfill the original intent of Congress in 1987, and would aid the retirement savings efforts of our college football coaches.

I want to thank the committee for the opportunity to address you today. I hope each of you will support H.R. 1981.

[The prepared statement follows:]

STATEMENT BY THE AMERICAN FOOTBALL COACHES ASSOCIATION REGARDING H.R. 1981, THE "QUALIFIED FOOTBALL COACHES PLAN TECHNICAL CORRECTIONS ACT OF 1993"

I. INTRODUCTION.

I am Charlie McClendon, Executive Director of the American Football Coaches Association ("AFCA"). Prior to becoming Executive Director of AFCA in 1982, I served as the head coach of the Louisiana State University football team for 18 years. AFCA represents more than 5,000 football head coaches and assistant coaches at 687 of our nation's colleges and universities throughout the United States.

I welcome this opportunity to appear before the Subcommittee, to discuss H.R. 1981, the Qualified Football Coaches Plan Technical Corrections Act of 1993. We are enormously grateful to Mr. Brewster, along with his other colleagues on the Ways and Means Committee, Mr. McCrery, Mr. Camp, Mr. McDermott, Mr. Bunning, Mr. Jacobs, Mr. Crane, Mr. Sundquist, and Mr. Thomas, for introducing this legislation. Companion legislation has been introduced in the Senate by Senator Orrin Hatch and Senator John Breaux as S. 1063.

H.R. 1981 would make a technical correction to legislation enacted by Congress in 1987 that was specifically designed to allow college football coaches to establish fully vested and fully portable retirement plans. I will describe for you the problem that has arisen and explain why we believe H.R. 1981 should be enacted to correct that problem.

II. NATURE OF THE PROBLEM.

As those of you who are fans of college football know, our teams play each game with enthusiasm and skill. At the end of the fourth quarter, the final score tells us whether we have won, lost or tied. Players and coaches and fans may not be happy with the final score, but at least we all know the result.

AFCA has recently learned that the tax law does not necessarily work the same way. In 1987 the Congress enacted legislation to specifically allow college football coaches to establish a tax qualified section 401(k) retirement plan. However, here it is 1993, and we do not know yet whether our coaches are winners or losers under that legislation.

A. College Coaches Need Access to a Qualified Retirement Program.

Let me explain our experience. In 1987, AFCA approached Congress and asked for a specific and very limited tax law change that would allow college football coaches the benefit of a section 401(k) plan established through the American Football Coaches Association. We indicated that most coaches and assistant coaches, unlike me, have short tenure at particular educational institutions. For instance, the average tenure of a coach or assistant coach at the smaller educational institutions is under three years. Therefore, it has been extremely difficult for the coaches to become vested in their college or university's retirement plan. Coaches needed retirement security regardless of their job tenure uncertainties. We asked Congress for a legislative solution that would allow us to form a qualified cash or deferred retirement benefit arrangement so that college coaches could contribute to a retirement plan that would be fully portable and fully vested.

B. Section 136 of P.L. 100-202.

We were most gratified with the response we received from Congress in 1987: One Hundred Fifty-One (151) House members and thirty-four (34) Senate members co-sponsored legislation that

amended the Employee Retirement Income Security Act of 1974 ("ERISA"). The amendment specifically permitted AFCA to establish a tax-qualified multi-employer plan with a section 401(k) feature. That amendment to ERISA was enacted on December 22, 1987, as part of Public Law 100-202.

Based on that 1987 ERISA amendment, the American Football Coaches Association established a retirement plan called the American Football Coaches Retirement Trust. We took all the necessary procedural steps to obtain a favorable determination letter from the I.R.S. that the trust constituted a qualified retirement plan. We received our first favorable determination letter on June 30, 1988, in which the I.R.S. confirmed that the cash or deferred arrangement sponsored by the Plan met the requirements of section 401(k) of the Internal Revenue Code of 1986, as amended. Additional favorable determination letters were also issued by the I.R.S. on July 3, 1989, and April 9, 1991. Then, in 1992, after the Plan had been in operation for over four years, the I.R.S. revisited the issue.

C. **Action Taken by the I.R.S.**.

On March 22, 1993, almost 5 years after we had received our initial favorable I.R.S. determination, the I.R.S. sent us a technical advice memorandum holding that the American Football Coaches Retirement Trust fails to satisfy the requirements of section 401(k). The I.R.S. has given us until December 31, 1993, to liquidate the Plan and to make distributions to Plan members. If we are forced to liquidate the plan, we will forfeit the significant expenses we have incurred to establish and maintain the plan and our coaches will be back were they were before 1987 with no vehicle to insure they have retirement plan.

The I.R.S. has taken the position that our Plan does not qualify as a result of another legislative provision enacted in 1987. We are convinced that no one, including the I.R.S., had any idea that this legislation would have any effect on our Plan at the time of its enactment. The specific legislation, section 9343(a) of the Omnibus Budget Reconciliation Act of 1987, was enacted into law on December 22, 1987, the very same day that P.L. 100-202, the law that amended ERISA to authorize our Plan, was enacted. Section 9343(a) of OBRA provides that the provisions of Titles I and IV of ERISA are not applicable when interpreting the Internal Revenue Code. The ERISA amendment that Congress gave us in 1987 was placed in Title I of ERISA. Therefore, as a strictly technical matter, the I.R.S. has concluded that the 1987 ERISA amendment does not do the one thing that it was intended to do: authorize our American Football Coaches Association to sponsor a fully vested and fully portable qualified retirement plan for college football coaches. Although there is no doubt that Congress intended to authorize our section 401(k) retirement arrangement, the I.R.S. has revoked our tax-exempt status. Consequently, we are faced with the situation that we will have to dissolve our Plan, unless Congress acts this year.

III. **WHAT H.R. 1981 WOULD DO**.

H.R. 1981 would correct the technical objections raised by the I.R.S., and allow us to continue our section 401(k) plan. In short, H.R. 1981 would fulfill the promise of the 1987 legislation.

Without H.R. 1981, we will have to liquidate the section 401(k) plan. Of course, this would cause a great disruption to the participants' retirement programs. Moreover, it would cause us to forfeit the significant costs we have incurred to establish and maintain our Plan in direct reliance on the 1987 legislation and subsequent favorable I.R.S. determinations.

IV. CONCLUSION.

In closing, I want to stress to Members of the Subcommittee that the need of college football coaches for this retirement savings arrangement remains great. Coaches and assistant coaches are still faced with short tenures at colleges and universities, and they have little chance to qualify under other retirement plans. Therefore, your favorable action on H.R. 1981 would fulfill the original intent of Congress in 1987, and would aid the retirement savings efforts of our college football coaches.

I want to thank the Committee members for the opportunity to address you today, and I ask that each of you support H.R. 1981.

Chairman RANGEL. Thank you. The Chair now yields to Congressman Cardin, a member of the committee, as well as Congressman Berman of California for the purpose of introducing a member of this panel.

Mr. CARDIN. I ask unanimous consent to place an opening statement in the record.

Chairman RANGEL. Without objection.

[The prepared statement follows:]

STATEMENT OF THE
HON. BENJAMIN CARDIN
SUBCOMMITTEE ON SELECT REVENUE MEASURES
JUNE 17, 1993

Mr. Chairman, first I want to thank you and Chairman Rostenkowski for holding these hearings. Today's hearing, along with those scheduled over the next two weeks, will bring before this subcommittee a number of very significant issues that deserve the attention of the Congress.

Of the many witnesses the subcommittee will hear today, I especially want to take this opportunity to mention two. Among the first panel of witnesses is Mr. Marvin Selter, of the National Staff Network, who is here to testify on a proposal to create a new safe harbor for pension coverage of leased employees. It is a particular pleasure to welcome our colleague and good friend Howard Berman, who will accompany Mr. Selter, to these proceedings.

The proposal that brings Mr. Selter to this hearing is similar to legislation that was introduced in the last Congress by a former member of this Committee, Congressman Brian Donnelly. I believe the proposal has been strengthened and refined in a number of respects, and I look forward to hearing the testimony and continuing to work on this issue.

Later today, Mr. Chairman, when the financial institutions panel testifies, the subcommittee will hear from a constituent of mine, Mr. Louis Eliasberg. Mr. Eliasberg, who is president of the Finance Company of America, a Baltimore company, will be here in that capacity as well as in his capacity as a member of the Board of Directors of the Commercial Finance Association.

He will discuss a proposal to redress an inequity in the tax treatment of small commercial finance companies. The Tax Reform Act of 1986 repealed for large banks the reserve method of accounting for bad

debts. Expressing a concern about the impact of the repeal of the reserve method on small banks, however, Congress permitted small banks, defined as banks with assets totalling less than $500 million, to continue to use the reserve method. Unfortunately, the '86 Act did not extend this treatment TO small commercial finance companies. These companies compete with small banks and face the same difficulties that led Congress to permit small banks to continue to use the reserve method.

In each of the last two Congresses I have introduced legislation to correct this oversight and treat small commercial finance companies the same as small banks. I am pleased that Mr. Eliasberg will be here today to further discuss this issue.

Mr. CARDIN. I want to introduce Marvin Selter, chairman of the board of the National Staff Network, who brings to our committee a proposal to create a new safe harbor for pension coverage of leased employees.

You may recall a similar proposal was placed before our committee last year by former Congressman Brian Donnelly. I believe the bill has been improved. I am looking forward to Mr. Selter's testimony. I would like to yield to Mr. Berman in whose district Mr. Selter resides.

STATEMENT OF HON. HOWARD L. BERMAN, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF CALIFORNIA

Mr. BERMAN. Thank you very much, Mr. Chairman.

I thank my friend and colleague, Mr. Cardin, for his interest in this issue and for allowing me to introduce to you my friend for many years, Mr. Marvin Selter, chair of the board of the National Staff Network, a business located in my congressional district. Sitting behind him is his son and general counsel to the business, Eric Selter. I have known them for a number of years. You are dealing here with witnesses who have tremendous reputations as businessmen in our community.

Their testimony before you today is part of Marvin Selter's continuing effort to really crusade—to shape up his colleagues and competitors in the employee leasing industry. His interest and what has become my interest, because I think the cause is so worthy, is to see employee leasing companies comply with the law, that loopholes be closed, that sham operators are weeded out, and that pension and welfare benefits are provided to these employees.

As I know this committee knows so well, there are tremendous problems with how part-time and leased employees are treated. The failure of pension and welfare benefits to be provided to these people is becoming a very serious problem in this country.

Mr. Selter has lent his considerable expertise to the development of a legislative proposal which he will describe for you today. It provides the industry with needed clarity while advancing what I think should be the important public policy of extending employee benefits to all American workers. I commend his testimony to you.

Chairman RANGEL. Mr. Selter, welcome to the committee.

STATEMENT OF MARVIN R. SELTER, CHAIRMAN OF THE BOARD, NATIONAL STAFF NETWORK

Mr. SELTER. Thank you, Mr. Cardin and Mr. Berman, honorable members of the subcommittee. Thank you, Mr. Chairman, for the opportunity to present testimony to you today with regards to our proposed legislation regarding section 414(n), employee leasing. The copy is hereby presented for the record.

This proposal allows an employee leasing organization to provide the maximum pension benefits allowed by law to its leased employees. Only when a leasing organization provides the mandated pension benefits would a recipient be allowed to have their leased employees included in the leasing organization's pension plan and not in the recipient's pension plan.

As the founder of the employee leasing industry over 20 years ago, I have been seeking a clear-cut rule to govern the provision

of pension benefits to leased employees and a way to define true employee leasing. This proposal is a result of 20 years of providing maximum pension and welfare benefits to thousands of employees.

Over the past 20 years, my company alone has paid out millions of dollars in pension benefits in addition to welfare benefits and has helped to prevent the pension abuse promulgated by crafty practitioners. Let me give you an example of what we are up against. A recent ad by a pension administrator contained the headline, "Comparability Plans Favor Highly Compensated Employees."

The article touts new IRS regulations which allow business owners to shift a substantial portion of their profit sharing contribution to key employees. Their comparison figures allow this plan to provide over 80 percent of the pension contribution to the key employee while allocating only 1 to 4 percent of the annual contribution to each rank-and-file employee.

This type of legal abuse only serves to encourage drafting of complicated plans that provide the highly compensated with maximum benefits. However, our proposal is much simpler and fairer. It guarantees maximum benefit for rank-and-file employees.

We have overcome possible objections by providing a lucrative vesting schedule. This means leased employees could retire at age 65 with sufficient income for the rest of their lives and the proposed legislation prohibits a recipient providing him or herself with any better vesting schedule, proving this proposal is not promulgated on the behalf of recipients but rather for the benefit of rank-and-file employees.

A recipient cannot provide him or herself a better pension plan by law. But there are additional benefits as well. The Government has announced its encouragement of private pension plans to supplement the Social Security systems, and statistics show clearly that private pension plan utilization is on the decline. We have discovered without this type of legislation or private rulings specific to benefits proposed, advisers will not sanction these leasing benefits despite the fact they are superior.

The proposed legislation also promulgates the administration's desire for portability of benefits. All of the new administration's proposals specifically address portability and this proposed employee leasing legislation provides just that.

Leased employees may change assignments without loss of seniority or benefits. Additionally, there are definite revenue saving items in the proposal as well. First, if a leasing organization meets the criteria in the legislation, then the recipient will be required to make estimated payroll tax depositories throughout the course of the year, but only be required to file one annual payroll tax return. Instead of the usual four quarterly returns, the IRS will only have to deal with one annual return per recipient organization.

If the estimated 100,000 recipient organizations utilize this safe harbor, the IRS will be relieved of dealing with over 300,000 payroll tax returns while still collecting taxes in a timely manner. According to the Mitre Corp.'s study released by the IRS, simplified reporting of wages and taxes could save State agencies over $300 million a year.

Please note this legislation includes the suggestion of the chairman, Mr. Rangel. Specifically, Mr. Rangel requested a mechanism for penalties should a leasing organization fail to provide the required benefits. We have incorporated a provision for the recipient to be liable for the leasing organization's failure to make contributions and provide the benefits. The IRS will be relieved of a costly function while the recipient will guarantee that these moneys will not only be paid on behalf of the leased employees but paid timely.

In summary, passage of this proposed employee leasing legislation will help prevent discrimination against rank-and-file employees versus the highly compensated. It will enhance economic growth for small- and medium-sized businesses throughout the country; and it will provide a mechanism for private industry to monitor and police these abusers within the employee leasing industry which will ultimately save business and Government millions of dollars.

Thank you again for the opportunity to present this testimony today. I am pleased and ready to answer any questions that you may have.

[The prepared statement follows:]

NATIONAL STAFF NETWORK

STATEMENT OF MARVIN R. SELTER,
CHAIRMAN OF THE BOARD, NATIONAL STAFF NETWORK

(818) 997-1100
(213) 873-NSN1
(800) 222-NSN1
FAX (818) 782-6136

Members of the Subcommittee:

Thank you, Mr. Chairman,

for the opportunity to present testimony to you today with regards to the proposed legislation regarding Section 414(n) employee leasing. This proposal would allow an employee leasing organization to provide the maximum pension benefits allowed by law to its leased employees. Only when a leasing organization provides the mandated pension benefits, only then would a recipient be allowed to have their leased employees included in the leasing organization pension plan and not in recipient's pension plan.

As the founder of the employee leasing indústry over 20 years ago, I have been seeking a clear-cut rule to govern the provision of pension benefits to leased employees as well as a way to define true employee leasing. This proposal is the culmination of 20 years of providing maximum pension and welfare benefits to thousands of employees. Over the past 20 years, my company alone has paid out millions of dollars in pension benefits in addition to welfare benefits and has helped to prevent the pension abuse promulgated by crafty practitioners.

Let me give you an example of what we are up against. A recent advertisement by a pension administrator contained the following headline, "Comparability plans favor highly compensated employees." The article touts new IRS regulations which have created an opportunity for business owners to shift a substantial portion of their profit sharing contributions to key employees. Their comparison figures allow this type of plan to provide over 80% of the pension contribution to the key employee while allocating a mere 1% to 4% of the annual contribution to each rank and file employee.

This type of "legal abuse" only serves to encourage practitioners to draft complicated plans that will provide the highly compensated with maximum benefits. However, our proposal is much simpler and fairer. It guarantees maximum benefits for rank and file employees as well.

Conversely, we have overcome all possible objections by providing a lucrative vesting schedule. This coupled with the proposed legislation's prohibition against a recipient providing him/herself with any better vesting schedule, can próve the strong argument that this proposal is not promulgated on behalf of recipients, but rather for the benefit of rank and file employees.

The proposed legislation will allow a recipient to take credit when a leasing organization provides a maximum 415(b) or 415(c) pension plan to rank and file employees. A recipient cannot provide him or herself a better pension plan by law. Actuarily calculated, this would mean that an employee could retire at age 65 with sufficient income for the rest of their life.

But there are additional benefits as well. As you know, while government has announced its encouragement of private pension plans to supplement the social security system, statistics clearly show that private pension plan utilization is on the decline. In all probability, if this proposal is not enacted, additional retirement plans will not be made available to employees throughout the country. For the last few years, we have discovered that without this type of legislation, or private letter ruling specific to benefits that are proposed, advisors will not sanction these

benefits despite the fact that they are superior.

The proposed legislation also promulgates the administration's desire for portability of benefits. This would include pension as well as health and welfare benefits as well. All of the new administration's proposals have been specifically addressing portability and this proposed employee leasing legislation provides just that. Employees under a leasing organization may change assignments without loss of seniority or benefits.

Additionally, there are definite revenue saving items in the proposal as well. First, if a leasing organization meets the criteria set forth in the legislation, then the recipient will be required to make estimated payroll tax depositories throughout the course of the year, but only be required to file one annual payroll tax return for him or herself. Instead of the usual four quarterly returns, the IRS will have to deal with only one annual return per recipient organization. If only 25% of the estimated 100,000 recipient organizations utilize this, the IRS will be relieved of dealing with over 300,000 payroll tax returns, while still collecting their funds in a timely manner. According to the Mitre Corp study released by the IRS, simplified reporting of wages and taxes could save federal and state agency costs in excess of $300 million dollars a year.

Not only will the IRS have to deal with fewer tax returns, but it will also have one source to audit and to ensure compliance. An employee leasing organization with thousands of employees will be filing only one return and be making its payroll tax depositories to the federal government 24 hours after payroll has been issued.

Please note that in promulgating this legislation, we have included the suggestion of the Chairman, Mr. Rangel. Specifically, Mr. Rangel was concerned that there was no mechanism for penalties should a leasing organization fail to provide the required benefits. We have incorporated a provision so the recipient will be liable for the leasing organization's failure to make contributions and provide the benefits. The IRS will be relieved of a costly function while the recipient will guarantee that these monies will not only be paid on behalf of the leased employees, but paid timely.

As a matter of fact, we propose a truly win-win-win situation. Rank and file employees are the big winners because they will be provided with maximum benefits allowed by law, ensured portability, and an opportunity to receive big corporation benefits provided by private industry and not paid for by government. Small to medium business is a winner because they can obtain cost effective benefits and the ability to provide pension in a cost effective manner. This will allow business to compete in a global society which will ultimately continue to stimulate our economy as well. Finally, government will be a winner by realizing a reduction in its administrative and policing function, a reduction in its costs due to a consolidation and universal method of reporting, and by less dependency on the social security system as more employees are provided with these maximum benefits and job security.

In summary, passage of this proposed employee leasing legislation will help prevent discrimination amongst rank and file employees versus the highly-compensated, it will enhance economic growth for small and medium sized businesses throughout the country, and provide a mechanism for private industry to monitor and police those abusers within the employee leasing industry which will ultimately save business and government millions of dollars.

Thank you again for the opportunity to present this testimony today. I am pleased and ready to answer any questions that you may have.

Chairman RANGEL. Thank you, Mr. Selter.

The Chair recognizes a member of this committee, Mr. Houghton, for the purpose of introducing a member of this panel.

Mr. HOUGHTON. Thank you, Mr. Chairman. I would like to introduce Mr. Kenneth Newton, New York State director of the National Volunteer Fire Council.

Mr. Chairman, I support his position to enact legislation that expands the Internal Revenue Code to provide benefits for volunteer fire rescue personnel. The legislation corrects an inequity and taxes these people only when they receive their retirement money, rather than as the money is vested.

Without further ado, I would like to introduce with great honor, Mr. Kenneth Newton.

STATEMENT OF KENNETH E. NEWTON, IMMEDIATE PAST PRESIDENT AND MEMBER OF THE EXECUTIVE COMMITTEE, FIREMEN'S ASSOCIATION OF THE STATE OF NEW YORK; AND NEW YORK STATE DIRECTOR, NATIONAL VOLUNTEER FIRE COUNCIL

Mr. NEWTON. Mr. Chairman, members of the committee, I am Kenneth Newton. I have been a volunteer fire fighter for over 25 years. I am currently the New York State director to the National Volunteer Fire Council. In addition, I am the immediate past president and current member of the executive committee of the Firemen's Association of the State of New York. I am appearing before you today to discuss a matter of vital importance to the national safety of the United States.

In many areas of the country, it is not economically or geographically feasible to provide fire and rescue services through paid career personnel. Instead, we must depend on services of volunteer fire and rescue personnel. As I am sure you are aware, it is often difficult to attain and retain volunteers in any endeavor; and it is especially difficult, while at the same time critically necessary, that volunteers be retained for extensive periods of time in the fire and service area.

In recent years, it has become very common for volunteer fire companies, which can either be governmental or nongovernmental tax-exempt entities, to provide volunteer fire and rescue personnel with service awards as a means not only to attract volunteers, but also to retain them on a long-term basis.

Typically, these benefits are provided under so-called length of service award programs which generally provide dollar benefits at retirement for years of voluntary service. At present, programs such as these are enforced in about three-quarters of the States, often pursuant to State statute.

It appears that section 457 of the Internal Revenue Code, which governs deferred compensation plans maintained by government and nongovernmental tax-exempt entities, may cause volunteers to be taxable on their service awards when they vest instead of when they receive after retirement.

Under section 457, an individual is not taxable for his income service award until he actually receives it, that is after retirement; but only if the value of this award for the year does not exceed the lesser of $7,500 or 33.3 percent of the individual's compensation. If

this limit is exceeded, then an individual is taxable as soon as he vests in the award, which almost always occurs long before payment begins at retirement.

Most volunteers do not receive any compensation for their services, and the small number that do receive something, they receive only a minimal amount, usually only to reimburse them for expenses as volunteers.

As a result, the value of the annual service award will always exceed 33.3 percent of the volunteers compensation from the fire company. And because volunteers almost always vest in their service awards long before receiving benefits at retirement, if section 457 applies, the volunteers will be taxed on benefits they will not receive for some time to come.

One of the proposals you have before you today is intended to solve the problem that volunteer fire and rescue personnel length-of-service award programs have as a result of the current tax law. The solution is for Congress to adopt legislation exempting these length of service programs for volunteer fire and rescue personnel from section 457. If this were done, the benefits would not escape taxation. Rather, taxation would simply be deferred until the benefits were actually received by the retired volunteer.

Likewise, service awards under these programs should also be exempt from FICA and Medicare taxation just as our benefit payments for tax-qualified retirement programs for retirees rewarded for their past service. This corrective legislation would support the important role that the volunteer fire and rescue personnel play in communities across the United States.

So in conclusion, I am asking that you show your support for the men and women who provide so vital a service to our country, the service of providing rescue and fire protection to our communities that rely on volunteers, by adopting legislation to provide the needed tax relief I have outlined.

I thank you for your time and attention. If you have questions, I would be happy to answer them.

[The prepared statement follows:]

STATEMENT OF KENNETH E. NEWTON,
NEW YORK STATE DIRECTOR, NATIONAL VOLUNTEER FIRE COUNCIL

A Proposal to Expand Code Section 457 Plans to Provide Benefits for Volunteer Fire and Rescue Personnel, Including Length-of-Service Awards, and to Exclude Such Awards from Federal Insurance Contributions Act Taxes

My name is Kenneth E. Newton, and I am the New York State Director on the National Volunteer Fire Council. In addition, I am the immediate past president and a current member of the executive committee of The Firemen's Association of the State of New York. I myself have been a volunteer firefighter for over 25 years.

I am appearing before you today to discuss a matter of vital importance to the national safety of the United States. I am concerned about our ability to successfully provide adequate fire and rescue services to our citizens. In many areas of the country it is not economically or geographically feasible to provide these services through paid career personnel. Instead, we must depend on the services of volunteer fire and rescue personnel. As I am sure you are aware, it is often difficult to attract and retain volunteers in any endeavor--and it is especially difficult, while at the same time critically necessary that volunteers be retained for extended periods in the fire and rescue services area.

Only if volunteers are willing to make a long term commitment to the effort will they be able to become and remain adequately trained to provide the level of fire and rescue services our citizens demand and deserve. But we need for your help in our efforts to attract and retain volunteer fire and rescue personnel on a long term basis.

In recent years, it has become very common for volunteer fire companies, which can be either governmental or non-governmental tax-exempt entities, to provide volunteer fire and rescue personnel with service awards as a means not only to attract volunteers, but also as a means to retain them on a long term basis. Typically, these benefits are provided under so-called Length of Service Award Programs, which generally provide dollar benefits at retirement for years of voluntary service. At present, programs such as these are in force in about three-quarters of the States, often pursuant to a State statute.

These service awards are taxable to the volunteer fire and rescue personnel as income at some point--either when they are actually received at retirement or when they become vested (which may be years before retirement). Exactly when the awards are taxable depends on what provisions of the tax laws apply.

It appears that section 457 of the Internal Revenue Code, which governs deferred compensation plans maintained by governmental and non-governmental tax-exempt entities, may cause volunteers to be taxable on their service awards when they vest, instead of when they are received after retirement. Under section 457, an individual is not taxable on his annual service award until he actually receives it (after retirement), but only if the value of the award for the year does not exceed the lesser of $7,500 or 33 1/3 percent of the individual's compensation. If this limit is exceeded, then an individual is taxable as soon as he vests in the award, which almost always occurs long before payments begin at retirement.

Based on an informal survey of a number of the members of the National Fire and Police Pension Fund Association, and further data from the former executive director of the International Association of Fire Chief's Foundation, there are approximately 150,000 volunteer fire and rescue personnel actively providing volunteer services in the United States who covered by service award programs. According to the survey results and the data obtained, either by state statute or practice, no compensation or other remuneration is provided for volunteers in New York, Pennsylvania, Maryland and Virginia. Approximately 43 percent of these volunteers reside in those states.

Another approximately 14 percent of these volunteers reside in states that pay only a nominal "expense reimbursement" of under $1,000. These states are Colorado, Connecticut, Georgia, Indiana, Kentucky, South Carolina and Tennessee.

In New Jersey, some fire commissioners are paid up to $3,000, but the rank and file

volunteers may receive in the neighborhood of $1,000 to $3,000 per year based on their level of service.

We have been able to find only one state, California, that pays certain volunteers on an hourly basis. This practice seems to have started as a way of providing manpower for forest fires. In at least two departments several volunteers have received $8,000 in one year. However, we have been assured that it is rare for any volunteers to exceed $6,000 per year.

Therefore, since most volunteers do not receive any compensation for their services, and the small number that do receive something receive only a minimal amount, usually only enough to reimburse them for their expenses as a volunteer, the value of an annual service award will always exceed 33 1/3 percent of the volunteer's compensation from the fire company. And because volunteers almost always vest in their service awards long before receiving benefits at retirement, if section 457 applies, the volunteers will be taxed on benefits they will not receive for some time to come.

As a general rule, wages are subject to FICA and Medicare taxation when paid, although there are various exceptions to this rule. However, pension payments from certain types of plans, such as tax-qualified retirement plans, are exempt from FICA and Medicare taxation altogether. There is no similar exception for awards under Length of Service Award Programs for volunteer fire and rescue personnel. Consequently, it appears that these awards may be subject to the rules for nonqualified deferred compensation plans, which would result in awards being subject to FICA and Medicare taxation when they are vested. As I said, this almost always is long before benefits are received.

One of the proposals you have before you today is intended to solve the problem that volunteer fire and rescue personnel Length of Service Award Programs have as a result of the current tax laws. This solution is for Congress to adopt legislation exempting these Length of Service Award Programs for volunteer fire and rescue personnel from section 457. If this was done, the benefits would not escape taxation. Rather, taxation would simply be deferred until the benefits actually were received by the retired volunteers. Likewise, service awards under these programs should be exempt from FICA and Medicare taxation, just as are benefit payments from tax-qualified retirement programs for retirees who are awarded for their past service. This corrective legislation would support the important role that volunteer fire and rescue personnel play in communities across the United States.

Congress has previously recognized the need to support volunteer firefighters by enacting Internal Revenue Code section 219(g)(6)(B), which allows volunteers to establish IRAs at the same time as they may be participating in a retirement plan on account of their activities as volunteer firefighters.

In the same vein, Congress has provided exemptions from FICA and Medicare taxation for certain classes of individuals performing services in special capacities similar to volunteer fire and rescue personnel. For example, Internal Revenue Code section 3121(i)(3) provides that, except for payments made on termination of service, allowances paid to Peace Corps volunteers are not included in wages for FICA or Medicare taxation. Further, the IRS has ruled that certain allowances paid to volunteer firefighters are not wages for FICA and Medicare taxation. (Unfortunately, these IRS rulings do not involve amounts similar to annual service awards for volunteer fire and rescue personnel.)

Corrective legislation would not violate the policy rationale for section 457. Section 457 was designed to limit the amount of tax-favored deferred compensation that governmental and tax-exempt entities can provide to employees and independent contractors under "nonqualified" deferred compensation plans--plans that do not satisfy the nondiscrimination and other tax-qualification requirements under the Internal Revenue Code. The policy rationale for the limits imposed by section 457 is that,

without such limitations, a governmental or tax-exempt entity would be able to use a "nonqualified plan" to provide its highly compensated employees with large amounts of nontaxable deferred compensation benefits without also having to provide nondiscriminatory benefits to its nonhighly compensated employees.

Of course, this rationale is inapplicable in the case of volunteer fire and rescue personnel. They receive little or no compensation for providing services as volunteers and thus would all be nonhighly compensated "employees." Therefore, because discrimination in favor of highly compensated employees is not possible in the case of volunteer fire and rescue personnel, Length of Service Award Programs should be exempt from section 457.

Further, Congress saw the need to exempt allowances paid to Peace Corps volunteers prior to termination of service from the definition of wages for FICA and Medicare taxation. In addition, plans providing for deferral of compensation established by governmental entities (other than section 457 plans) are exempt from FICA and Medicare taxation. The same treatment should be afforded to annual deferrals by both governmental and tax-exempt entities to Length of Service Award Programs for bona fide volunteer fire and rescue personnel.

Finally, the corrective legislation we are asking you to adopt will result in only small amounts of Federal revenue loss. First, the total number of affected taxpayers would not be significant and, in any event, the amounts involved would be small. Second, the government or tax-exempt entity providing the retirement benefits pays no income tax, so there would be no revenue loss resulting from a deferral in the potential deduction of the retirement benefits from the year the benefits are earned and vested to the year the benefits are actually received by the volunteers.

So, in conclusion, I am asking that you show your support for the men and women that provide so vital a service to our country--the service of providing fire and rescue protection to our citizens in the many communities that rely on volunteers--by adopting legislation to provide the needed tax relief I have outlined.

I thank you for your time and attention. If you have any questions I would be happy to answer them.

Chairman RANGEL. Thank you so much, Mr. Newton. The only panelist who has not testified in front of this committee is one who has had no Member of Congress to introduce him. So that he doesn't leave frustrated, I would like to introduce to the Ways and Means Committee Mr. Shulman.

He is from the National Association of Computer Consultant Businesses opposing a proposal to create a new safe harbor under which lease employees could be excluded from the pension plans of several recipient organizations. He testified on September 16, 1991, at hearings on pension simplification and we are pleased to hear your views today, Mr. Shulman.

STATEMENT OF HARVEY J. SHULMAN, GENERAL COUNSEL, NATIONAL ASSOCIATION OF COMPUTER CONSULTANT BUSINESSES

Mr. SHULMAN. Thank you for your introduction. I am a patient witness. I appreciate your kind remarks. Although NACCB supports the concept of increasing the number of workers covered by pension plans—and from what I have heard about Mr. Selter's operation, hearsay, it is a first-class operation—we do oppose the proposal to create a new safe harbor for leased organizations.

Our comments will focus on two main issues; first, the narrow issue of the concept of a safe harbor itself and how it would be implemented; but secondly, Mr. Chairman, the more fundamental problem with the current law: Who is a leased employee, which gets us into the safe harbor to begin with?

The thrust of the new proposal seems to be that if a leasing organization meets a number of detailed criteria, the IRS will provide it with some sort of special safe harbor. These criteria relate to matters like employer contributions, vesting requirements, accounting matters, et cetera.

We believe that this safe harbor concept related to such criteria places the Government in a position of giving a good housekeeping seal of approval to certain companies. Make no mistakes: Even in good faith, these companies will be able to take their safe harbors to clients and warn those clients to do business only with such safe harbor firms.

The leased employee laws will have grown from a well meaning effort to protect workers into a broader Federal regulatory scheme which, as experience shows in other areas, imposes unreasonable startup burdens against new entrants, excessive costs for smaller businesses, and is a bonanza to a selected although well-motivated few.

The proponents of the safe harbor also make the judgment, Mr. Chairman, that maximum benefits is the preferable tradeoff to reasonable benefits plus a higher salary. Employers cannot manufacture money. Such tradeoffs must be made; but the Government should not create a safe harbor that tells some firms, because they pay higher salaries and yet reasonable but not maximum benefits, that somehow they lose the safe haven.

We also see problems with administering such a safe harbor system. The IRS would have to evaluate hundreds, maybe thousands of leasing organizations. The IRS job of reviewing even simpler pension plan requirements for nonleasing organizations is difficult

enough. The IRS evaluations of safe harbor plans would have to be on an ongoing basis since plans and procedures change. Assuming the complexity and the paperwork burdens could be overcome, is Congress really ready to fund the new IRS positions required to audit and monitor these plans?

We believe, Mr. Chairman, that an effort to create a new safe harbor really ignores the fundamental problems with the leased employee laws, that is the unreasonable and arbitrary definition of who is a leased employee.

Have you heard the term, Mr. Chairman, "outsourcing"? In outsourcing situations a large employer fires entire departments of low-level employees, has these employees hired by a new employer and then subcontracts to the new employer to have the very same work done. Because the outsourced work is performed under the direction of the subcontractor in an adjacent rented building, the subcontractor is not a leasing organization and the workers are not leased employees. The very type of worker supposed to be protected by the leased employee laws escape protection.

The same thing for administrative and clerical people. These people are sent to clients for up to a year and then transferred to another client. Once again these are the type of workers supposed to be protected by the leased employee laws, but they escape protection because they haven't performed work for one service recipient for more than 1 year.

Who is caught up in the leased employee laws? In many cases it is technical service firms like NACCB members, which historically have not been considered in the leasing business. Much like a law firm would provide a team of legal specialists to a client involved in an antitrust case for a year or two or three, technical service firms provide computer and engineering professionals as specialists to their clients. Unfortunately, we who pay people very, very well are considered leasing organizations, and yet the kind of situations I have described are not covered by the laws. What we think is needed here, Mr. Chairman, is not a new safe harbor. We need to exempt professionals from the leased employee laws and cover the type of lower level workers I have described.

In closing, our suggested definition is in our written testimony. It differs somewhat from last year's legislation, and we hope to work with you to make sure that the proper workers are covered and that the leased employee laws do not become the kind of impediment they are to other firms. Thank you.

[The prepared statement follows:]

TESTIMONY OF
NATIONAL ASSOCIATION OF COMPUTER CONSULTANT BUSINESSES
HARVEY J. SHULMAN, GENERAL COUNSEL
Before the
SUBCOMMITTEE ON SELECT REVENUE MEASURES
of the
HOUSE WAYS AND MEANS COMMITTEE
June 17,1993

Mr. Chairman, the National Association of Computer Consultant Businesses ("NACCB") opposes the proposal to create a new safe harbor under which leased employees can be excluded from the pension plans of service recipient organizations. We testified at your September 16, 1991 hearings on Pension Simplification on the broader issue of "leased employees", and we are pleased to give you our views today.

I. Description of NACCB

NACCB has about 150 member companies -- which are technical services firms -- with a total of over 500 offices throughout the United States. Our members provide highly-skilled computer and engineering professionals to service recipient clients in need of technical support for special projects. Project durations can typically last anywhere from several months to two or three years, and sometimes they are broken down into separate phases. The professionals who work on these projects are either employees of our member technical services firms or, in appropriate cases, subcontractors, and they often earn $50,000 per year or more.

Our comments on the proposal for a new safe harbor will focus on two key issues: First, we will address the narrow issue of the safe harbor itself, both as a conceptual matter and as it would be implemented. Second, we will discuss the more fundamental problem with the current "leased employee" law. We believe that these two issues are inextricably intertwined.

II. The Proposal for New Safe Harbor Will Only Further Complicate the Administration of the "Leased Employee" Rules

NACCB believes that the proposal for a new safe harbor, if adopted, would only further complicate the administration of the "leased employee" rules.

The thrust of the new proposal is that if a "leasing organization" meets a large number of detailed criteria for a safe harbor, then the IRS would "register" the "leasing organization". Assuming that the new proposal is similar to a proposal advanced in 1991, among the criteria to be met are those involving employer contributions which equal limitations under Section 415(b) or (c) of the Internal Revenue Code; satisfaction of vesting requirements under Section 416(b)(1)(B) of the Code; and accounting for certain services that are not required to be taken into account by Section 411(a)(4)(D) of the Code. In addition, the "leasing organization" would also be treated as the "sole employer" of a worker if it had the sole right to hire, terminate and transfer the worker; if it directed, controlled and evaluated the manner and means of the worker's performance; if it provided universal fringe benefits; and if it billed the service recipient on a total fee basis rather than on a pass-through basis; etc.

We object to the fact that the concept of "registration" places the government in the position of essentially giving a "Good Housekeeping Seal of Approval" to certain companies. Make no mistake: these companies will then have every incentive to take their IRS registration certificates directly to service recipient clients and, in a blatant manner to harm competitors, they may warn those clients to do business only with "registered" firms in order to avoid potential pension plan problems. Most directly harmed would be those "leasing organizations" which can qualify for registration, but which choose not to expend the time or money to go through the registration process. The "leased employee" laws will have grown from a well-meaning effort to protect workers into a whole new federal licensing scheme which -- as experience shows in other areas -- imposes unreasonable start-up barriers against new entrants and excessive costs upon smaller businesses.

Mr. Chairman, not only do we quarrel with the concept of "registration" -- however well-intentioned it might be -- but we also see major problems with administering such a system. The requirements for registration will not be self-enforcing. The IRS would have to evaluate each and every "leasing organization" that filed for registration. Because of the potentially anti-competitive effects on firms that choose not to register, perhaps hundreds if not thousands of firms would decide to register -- even if registration was not universal. We already know the problems faced by the IRS in applying the

even simpler pension plan requirements to non-"leasing organizations", and we can only imagine the added difficulty of applying the new and complex testing criteria of the proposed safe harbor to "leasing organizations". Of course, IRS evaluations would have to be done on an ongoing basis since organization's pension plans and operating procedures that affect registration can change from year-to-year; there would then have to be procedures for "de-registering" organizations that no longer met the criteria. Assuming the complexity of these tasks could be overcome, where is the IRS going to get the personnel to perform these functions? Is Congress ready to fund such new positions?

For the above reasons, NACCB opposes the concept and implementation of a registration system for "leasing organizations". Moreover, as we explain below, we believe that the concept of registration takes reform of the "leased employee" laws in the opposite direction from the type of simplification that is really required.

III. Appropriate Reform of The Leased Employee Laws Should Focus on the Re-Definition of "Leased Employee" Because the Existing Laws Lead to Unreasonable and Arbitrary Results

Mr. Chairman, NACCB believes that an effort to create a new safe harbor under the "leased employee" laws ignores the more fundamental problems with those laws. We all know the genesis of the "leased employee" laws: employers which fired their employees and then "leased" them back through another company in order to avoid providing those employees with certain benefits. NACCB believes that the employees in this type of situation are certainly "leased employees" and they should be treated like employees of the service recipient for purposes of testing the service recipient's plans.

On the other hand, the "leased employee" laws go far beyond the situation which first generated Section 414(n). Unfortunately, these laws appear to be a mechanism by which Congress is attempting -- in an indirect manner -- to impose pension plan obligations upon certain types of employers which are really not "leasing organizations", such as NACCB member firms. If Congress wants employers to provide pension plans, it should apply this requirement to all employers -- and it should tackle that issue head-on and should not use an indirect approach. The present "leased employee" laws, as we explain below, lead to unreasonable and arbitrary results.

Have you heard of the term "outsourcing", Mr. Chairman? Did you know that in "outsourcing" situations large employers have fired entire departments of lower-level employees, have arranged to have these former employees hired by a new employer, and then have subcontracted with the new employer to have the very same work done? Because the "outsourced" work is performed under the direction of the subcontractor and in an adjacent room or building rented by the subcontractor, the subcontractor is not a "leasing organization" and the workers are not "leased employees". The very types of workers that are supposed to be protected by the "leased employee" laws escape protection in this situation.

Let's also look at the situation involving administrative workers like secretaries, receptionists, data entry workers, and other clerical workers. Do you realize that these workers are often sent to one service recipient client for up to a one year period and then are systematically transferred to another client? In such situations, the transfers are easily effectuated and within days the workers adjust to the new client. Yet these workers -- the very types of workers supposed to be protected by the "leased employee" laws -- escape protection because they have not performed services for one service recipient organization for more than one year.

But who is "caught up" in the "leased employee" laws, Mr. Chairman? In too many cases, those firms entangled in these laws are technical services firms like NACCB members which are <u>not</u> -- and have not historically been considered to be -- in the "employee leasing" business. Technical services firms do not exist because their service recipient clients want to avoid including workers in benefit plans; technical services firms exist because the rapidly changing technology in the computer and engineering industries typically means that service recipient clients cannot possibly obtain from only their own in-house employees the degree of technical expertise and specialization required. In such instances the service recipient clients seek the services of technical services firms to locate and provide the services of these "outside" workers for such special project work. Much like a law firm might provide a team of legal specialists to help a client with a major antitrust law problem -- even though the client already has an in-house general counsel -- so too technical services firms like NACCB members provide technical specialists to their clients.

Unfortunately, however, the present "leased employee" definition in the Internal Revenue Code is so broad that computer and engineering professionals paid by technical services firms, but who perform on-site services for clients, are often alleged to be "leased employees". The adverse consequences of this conclusion are real and serious: at the end of one year of service, these professionals are removed from projects by service recipient clients who do not want to take the risk that their own benefit plans might be jeopardized by using such workers and who do not want to undertake the administrative and paperwork burdens to prove otherwise. The service recipient clients thereby often find that their own projects are delayed and over-budget because they must locate new "outside" workers to pick up where the removed "outside" workers have left off.

Although these results seem bizarre, Mr. Chairman, they regularly occur because of how the Internal Revenue Code defines "leased employees". Ironically, relatively highly-paid, professional workers -- those least in need of federal protection -- are the victims of the "leased employee" laws.

NACCB believes that the only way to tackle to "over-inclusiveness" and "under-inclusiveness" of the "leased employee" laws is not through the creation of new safe harbor, but through the re-definition of who is a "leased employee".

IV. The "Control" Definition of "Leased Employee" in 1992 Legislation Must Be Further Refined If the Goals of Section 414(n) Are To Be Met in a Reasonable Manner

Mr. Chairman, last year both the House and the Senate proposed a new definition of "leased employee" that would replace the currently overbroad test in Section 414(n) -- which inquires whether work has been "historically performed" by employees -- with a test of whether the services performed are "under the control" or "under any significant direction or control" of the service recipient client.

NACCB appreciates the effort made by the Congress to move away from the clearly unacceptable "historically performed" test. However, we believe that above terminology of the "control" test will be virtually as broad and troublesome as the existing test.

A. General Problems With a "Control" Test

By way of background, under present law the IRS inquires whether the leased employees are performing services that have been "historically performed by employees". To determine if services have been "historically performed by employees", the IRS has asked whether "it was not unusual for services of [the] type [at issue] to be performed by employees ...." Of course, to determine whether "it was not unusual" for "employees" to perform such services, it is necessary to determine who is an "employee" -- and that requires application of the IRS 20-question common law employment test.

The common law employment test is, in reality, a form of "control" test. As the IRS Manual states, "Under the common law test, a worker is an employee if the person for whom he works has the right to direct and control him in the way he works both as to final results and as to the details of when, where and how the work is to be done.... The factors or elements that show control are described below in the following 20 items." IRM-Administration, Exhibit 5(10)00-4.

Unfortunately, it is precisely this same "control" test which has been long-criticized. The following words have been used by respected government officials and in comprehensive government studies to describe the "control" test: "complex", "open to broad and inconsistent interpretation", "extremely difficult to apply", "extremely subjective and often inconsistently applied by the IRS", "lack[ing] precision and predictability", "produc[ing] inappropriate results", and "not yield[ing] clear, consistent or satisfactory answers".

There are several reasons why the "control" test has been thus criticized, some of the major reasons being that:

* There are too many "control" factors to consider.

* Even on an individual basis, many of the factors are too imprecise, subjective and unpredictable.

* Attempts to balance several "control" factors to determine, on an overall basis, if there is "control" are too difficult because:

  -- it is unclear how many factors must be present or absent to determine whether there is "control", and

  -- it is unclear which factors must be present or absent to determine whether there is "control" since each factor may have a different degree of importance in any particular situation.

* In virtually every working relationship of any type, there is always some degree of "control" over a worker by a recipient of services. Hence, there is an inherent problem in drawing a line between how much "control" is too much "control".

* In view of the imprecise, subjective and inherently encompassing nature of the "control" test, the IRS has historically applied it in an overly broad manner which results in a conclusion of employment in the overwhelming number of situations. For example, according to the April 1991 issue of The Practical Accountant, in only 8% of the Private Letter Rulings issued by the IRS between January 1, 1987 and March 31, 1988, did the IRS conclude that a worker was not

an employee; for the period July 1, 1989 through September 30, 1990, only 75 Private Letter Rulings were issued on the same issue, and in only one of these did the IRS conclude the worker was not an employee.

Governmental leaders have repeatedly made these same points in the well-recognized Report of the Comptroller General, GGD-77-88, entitled "Tax Treatment of Employees and Self-Employed Persons by the Internal Revenue Service: Problems and Solutions", (November 1977); in Hearings on H.R. 3245 before Subcommittee on Select Revenue Measures of House Ways & Means Committee, 96th Cong., 1st Sess., at pp. 5, 9; in a November 1990 House Government Operations Committee Report; in a March 1991 study released by the Treasury Department, entitled "Taxation of Technical Services Personnel: Section 1706 of the Tax Reform Act of 1986"; and in virtually unanimous testimony from over 20 witnesses in a hearing entitled "Misclassification of Employees and Independent Contractors for Federal Income Tax Purposes", before the Subcommittee of Select Revenue Measures of the House Ways & Means Committee, July 23, 1992.

B. Problems with a "Control" Test for "Leased Employees"

Unfortunately, we do not see a great deal of difference between the "control" tests adopted in last year's "leased employee" legislation and the 20-question common law employment test which has been so soundly criticized. What difference may exist is simply a matter of degree, rather than of kind, and the degree is quite small, as we now explain.

We have already identified the problems with the "control" test in the employment tax area. Addressing these problems one-by-one, it becomes clear that the "control" test for "leased employees" does little to solve them.

As to the number of factors that must be considered to determine if there is "control" by the service recipient, we appreciate the fact that last year Congress attempted in legislative history to identify particular factors that were relevant under last year's legislation. However, the staff's explanation explicitly does not restrict a determination of "control" to only the identified relevant factors; rather, according to the explanation, the taxpayer's "facts and circumstances" must be considered, and factors that are relevant are said to "include" the identified factors. It could well be that there are 10 relevant factors, or 15, or even 20 or more -- a possibility that confronts the taxpayer with too many factors to consider, which is a major problem with the employment tax "control" test.

Our concern about the need to consider too many factors is not eliminated by the legislative history's identification of certain common law employment "control" factors that are not relevant to the "control" test which would be applied to "leased employees." In fact, the deletion of these factors -- which would otherwise tend to show that the service recipient does not exercise "control" -- only further confuses the issue of how to decide what other factors are relevant or irrelevant.

As to the fact that many of the "control" factors are too imprecise, subjective and unpredictable, again we see very little difference between the "control" test for "leased employees" and the common law employment "control" test. For example, in IRS employment tax audits, major controversies have arisen over whether it constitutes "instructions about when, where and how to perform services" if a firm instructs a worker that he or she can begin a project by one date and must finish it by a second date. Taxpayers take the reasonable position that such instructions hardly amount to "control" over work hours, whereas the IRS often takes the opposite view. Likewise, taxpayers and the IRS typically disagree over what degree of involvement by a service recipient amounts to "supervision" over a worker. Disputes even arise over whether a service recipient is "controlling" the order or sequence in which a project must be completed where the services being performed are during only one stage of a multi-stage project -- such as building construction -- and it is obvious that certain stages must be completed before others can begin. Yet, even though substantial disputes exists over these factors -- because they are too imprecise, subjective and unpredictable -- these same factors have been identified as relevant to a determination of "control" under the "leased employee" test.

As to the issue of the difficulty in balancing several factors to determine, on an overall basis, if there is "control", again we see little difference between the tests under the "leased employee" legislation and the common law employment "control" test. It is seldom that all of the relevant factors which point towards "control" will be present. Major problems will exist regarding the weight to be given to each factor, as well as how to balance the existence of some relevant factors against the non-existence of other relevant factors. This has clearly been the experience in the common law employment "control" test, and there is no reason why it would be much different under either of these bills.

As to the concern that there is always inherently some "control" by a service recipient over a worker, this problem is not solved in the least by last year's "leased employee" legislation. By implicitly focusing on the existence of actual "control" and identifying certain relevant factors -- such as "supervision" by the service recipient -- these bills have failed to recognize a point made by one of America's great jurists, Judge Learned Hand, several decades ago. In discussing an IRS claim that a

taxpayer's "control" over certain workers meant that the workers were the taxpayer's employees, Judge Hand stated:

> In the case at bar the plaintiff did intervene to some degree; but so does a general building contractor intervene in the work of his subcontractors. He decides how much the different parts of the work must be timed, and how they shall be fitted together; if he finds it desirable to cut out this or that from the specification, he does so. Some such supervision in inherent in any joint undertaking, and does not make the contributing contractors employees.
> Radio City Music Hall Corp. v U.S., 135 F.2d 715, 718 (2d Cir. 1943) (emphasis added).

Precisely because of the above concerns, as is the case with the common law employment "control" test, the problem remains that the IRS can engage in an overly broad interpretation of the definitions in last year's legislation. Indeed, there is no sound basis for any confidence that the IRS will draw reasonably clear lines which would exclude from the new definition of "leased employees" more than a tiny fraction of workers who are likely to be designated as "leased employees" under the currently "historically performed by employees" test in Section 414(n). In short, if Congress truly believes that the present test is too broad and over-inclusive, so few workers will be affected by last year's "leased employee" definitions that that legislation cannot be called "reform" legislation.

Finally, there is a new problem here which does not exist with the common law employment "control" test. As we will explain, rather than represent pension "simplification", we believe that it is likely that last year's legislation would only introduce "complication" to the "leased employee" issue. What we mean is that by virtue of its overbreadth, the "historically performed by employees" test in the current law is actually relatively simple to apply once it is understood that the IRS will almost always conclude that a worker is a "leased employee". In contrast, by introducing a new degree of "control" that is different from the existing degree of "control" which classifies a worker as a common law employee, the "leased employee" legislation from last year only further complicate matters. More specifically, if either of these bills is adopted, there will really be three degrees of "control" that are relevant to the analysis of every worker's status:

* If there is some "higher" degree of "control" by a service recipient, then a worker will be considered to be the common law employee of the service recipient.

* If there is some "mid-level" degree of "control" by a service recipient -- but less than the degree of "control" which would classify the service recipient as a common law employer --then the worker will be considered to be the "leased employee" of the service recipient.

* If there is no "control" or only a "minimal" degree of "control" in the service recipient, then the worker is neither a "leased employee" nor a common law employee of the service recipient.

In addition, in all three situations there will still remain the separate question of whether or not there is enough "control" by the firm which provides the worker to the service recipient so that such firm is the common law employer of the worker. However, in answering this separate question of "control" in the employment tax context, taxpayers will have to consider some, but not all, of the very same factors that are relevant to the determination of "control" in the "leased employee" context.

In conclusion, we believe that the "control" definition of "leased employee" in last year's definition will not solve -- and may further exacerbate -- the problems with the existing "historically performed by employees" language in Section 414(n). As with the common law employment tax "control" test, taxpayers will have too many relevant factors to consider; they will be uncertain about how to interpret several vague factors; they will not be clear about how to weigh each factor and how to balance the different factors together; they will have to consider factors which inherently include elements of "control" in most any situation; they will be left with a test which is likely to lead the IRS to engage in an overly broad interpretation of who is a "leased employee"; and they will be faced with the confusing task of distinguishing between two different concepts of "control" which have a substantial overlap of relevant factors. This is not simplification.

C. Possible Reforms of the "Control" Test

NACCB believes that if Congress wants to use some form of a "control" test, it would be most appropriate to use the "control" test in last session's bill H.R. 2641, which differs in a significant respect from the "control" tests that passed the House and the Senate last year. Rather than focusing on the broad concept of "control" with its numerous component factors, the H.R. 2641 "control" test classifies a worker as a "leased employee" if "the [service] recipient exercises primary control over the manner in which such services are performed." We believe that this "manner of

control" test -- along with an exclusion for "professionals," as discussed below -- is far more preferable to the much broader "control" tests in the other bills for a number of reasons.

First, the H.R. 2641 test focuses on only one aspect of "control", i.e., control over "the manner in which such services are performed." Although the "manner" of performing services might be described by a further reference to some other factors, it is clear that such other factors would be fewer in number and more narrow in scope than the factors that otherwise determine the existence of "control" as defined other legislation. For example, we do not believe that the "manner in which services are performed" would include consideration of directions as to the result that must be obtained by the performance of the services, or even of general instructions by the service recipient as to when and where the services should be performed; nor would a requirement that the services be performed by a particular worker amount to "control over the manner in which the services are performed". In contrast, where a service recipient provides detailed directions and instructions on the steps and methods to be used to achieve a stated result, this might constitute "control over the manner in which the services are performed."

Second, because fewer and more narrow factors would be considered in determining "control over the manner in which the services are performed", there would be less vagueness in this test. A line between the existence or non-existence of this type of "control" could be more easily drawn by taxpayers who would be better able to weigh the existence and non-existence of each individual relevant factor, and then arrive at an overall determination of whether such "control" exists.

Third, we believe that the H.R. 2641 test comes closest to covering the type of workers about whom Congress was most concerned when it initially adopted Section 414(n): typical support staff employees -- like clerical workers, receptionists, and licensed practical nurses in doctors' offices -- who perform routine support services in a "manner" that is directed and controlled by service recipients. Other types of workers whose manner of performing services is not controlled by a service recipient -- including high-level computer systems analysts and programmers who exercise a substantial amount of discretion and independent judgment in how to perform their services -- were never intended to be covered by Section 414(n) and would not be covered under the test in H.R. 2641.

Although we believe that H.R. 2641 offers the most predictable and reasoned definition of "leased employee", we also believe that some further refinements should be made in the statutory language in this bill so that the potential problems associated with any form of "control" test can be minimized.

In particular, we urge that the phrase "the recipient exercises primary control over the manner in which such services are performed" should be changed to read "the recipient primarily provides detailed directions and instructions as to the manner in which the services are to be performed." This change would accomplish two major benefits:

* It would remove the word "control" and instead focus on "directions and instructions" -- and thus hopefully remove most of the critical "baggage" from the employment tax area that is associated with the word "control".

* It would focus only on "detailed" directions and instructions as to the manner in which the services are to be performed -- and thus preempt any argument that "general" instructions and directions might suggest that the worker is a "leased employee". We appreciate that there may be some dispute over what is "general" versus "detailed", but at least the statutory language will serve to narrow the degree of the dispute.

We also urge that if H.R. 2641 is used, it should be amended to specifically exclude "professionals" from the definition of "leased employee". This exclusion would accomplish two major goals:

* It would establish for some types of work a "bright line" between covered and non-covered workers. In particular, it seems that the emphasis in last session's version of H.R. 2641 is to cover only those workers for whom the service recipient controls the "manner" in which the work is performed. This type of worker is on the opposite end of the spectrum from a worker who typically exercises significant discretion and independent judgment in performing his or her work. The latter type of worker is epitomized by the "professional". Rather than requiring a painstaking application of the "manner" test to every type of occupation, it is appropriate to create an explicit exclusion for "professional" workers.

* The inclusion of a "professional" exemption would also allow Congress to specify which types of workers would be considered "professionals" for purposes of this law. The IRS could be given authority to add other classes of "professionals". There is clear precedent for this type of exemption in other laws. For example, the Fair Labor Standards Act includes a "professional" exemption from the overtime laws, and the Department of Labor has defined the term "professional."[1/]

With the above changes, a new H.R. 2641 would read as follows:

> "(C) the recipient primarily provides detailed directions and instructions as to the manner in which the services are to be performed, provided however that professional workers (as defined by the Secretary) shall not be included within this definition."

D. Examples of the Presence and Absence of "Detailed Directions and Instructions As to Manner" in Which Services Are Performed

Even with a shorter, more predictable definition of "leased employee", Congress must provide clear illustrations of who is not a "leased employee" and who is. This will assist the IRS -- and ultimately the courts -- in assuring implementation of Congressional intent as to the breadth of any new definition.

We appreciate that last year's legislative history has done this in a limited respect. Certainly secretaries and similar support staff would be considered "leased employees" because, typically, service recipients which utilize temporary secretarial help often require a secretary to greet visitors in a certain manner, to take telephone messages in a certain way, to type documents in a certain format, and to file documents in a certain order. These are "detailed directions and instructions as to the manner in which the services are to be performed."[2/]

On the other hand, where a service recipient uses "outside" computer programmers, systems analysts, and other similarly skilled workers to provide their services on a particular computer project or to meet requirements that are not being met by a service recipient's own "in-house" employees, these "outside" professionals should generally not be considered "leased employees" regardless of whether they are employees of an "outside" technical services firm or are independent contractors who have contracted through an intermediary "broker". In these typical situations the service recipient would not primarily provide detailed directions and instructions as to the manner in which the services are to be performed. Rather, the manner in which the work is done is usually established by the worker using his or her own discretion and judgment -- albeit under a timetable and in stages set by the service recipient according to well-accepted quality assurance procedures and techniques in the industry. Also the workers would be considered exempt "professionals".

IV. Conclusion

NACCB believes that a safe harbor of the type proposed for "leasing organizations" which "register" with the IRS is an inappropriate solution to the current problems with Section 414(n). Instead, Congress should re-define the term "leased employee" so that Section 414(n) applies only to the truly abusive situations which require governmental intervention.

[1/] Where the Department of Labor has interpreted that term too narrowly, Congress has intervened. See, e.g., P.L. 101-583, where Congress directed the Department to include computer systems analysts, computer programmers, software engineers and similarly skilled workers as "professionals."

[2/] The legislative history also referred to "nurses" as a class of "leased employee." We note that there are very different types of nurses working in very different types of situations and not every nurse would appear to be a "leased employee."

Chairman RANGEL. Thank you, Mr. Shulman. The Chair would like to turn the gavel over to Mr. Hoagland.

Mr. HOAGLAND [presiding]. Thank you, Mr. Shulman, for your testimony. Do any members of the committee have questions of any of the panelists?

Mr. JACOBS. Yes, I do.

Mr. HOAGLAND. Mr. Jacobs.

Mr. JACOBS. I wanted to say to the Chief Justice that I had occasion to call some officials recently about this problem of State judges and the disparity between the treatment of State judges and Federal judges. I inquired that if the subcommittee and if the committee should deny the relief to the State judges, would the committee be understood in looking to the same denial or that as extending the same nondiscrimination rules to Federal judges, and I was told that there already is a nondiscrimination rule applied to Federal judges.

Now, I am always willing to learn, of course, but what I learned was that the staff member who said that, said it from ignorance. He did not understand what senior status is. I should hasten to add that in the case of senior status, which essentially is retirement, I know that judges, Federal judges with senior status, if they get bored with gardening or something can come downtown and hear cases and all that, but essentially to the naked eye, senior status is retirement. It is unique, I think, in our government apparatus throughout our society in that no contribution by the individual has ever been made for retirement benefits, so there really, I think, is a difference, and I like the point that you made that all employees are, in fact, treated similarly because in this situation all employees are judges. That is the category, so I, for one, and I suspect many other members of this subcommittee sympathize with the proposition you have made, sir, and your brilliance obviously has made up for the long years we hope you continue to serve in your lofty capacity.

Thank you, Mr. Chairman.

Mr. HOAGLAND. Mr. Camp.

Mr. CAMP. Thank you, Mr. Chairman. I just wanted to join my colleague, Mr. Brewster, in welcoming Charlie McClendon to the committee. I am a cosponsor of H.R. 1981 and believe that it is meritorious and deserving of our attention. Thank you.

Mr. HOAGLAND. Mr. Cardin.

Mr. CARDIN. Thank you. Mr. Shulman, I appreciate your testimony. The leased employee rules are obviously very complicated and have caused problems for many different industries. If I understand your testimony, you acknowledge a problem within the leased employee rules, but would prefer to use an exemption to deal with it. That, I think, could create additional problems and I am wondering, Mr. Selter, if you would just respond to the point that Mr. Shulman made.

Mr. SELTER. Thank you, sir. First of all, under an employee leasing proposal under the safe harbor, all rank and file, regardless of age, without discrimination and so forth, are included in the plan, and the plan has to be equal to the recipient's plan because it is a maximum 415 plan, which is the most money you can put away for any employee under ERISA. It will be automatically comparable

to any of the clients or the recipients plan. Second, the recipient cannot have a better plan than a maximum 415, nor can the vesting schedule be any better than this particular plan.

Second, and I think probably most importantly, under the employee proposal that we are making for safe harbor, all of the employees in a leasing organization will have complete undisputed portability. If they go from client 1 to client 2 to client 3 under the proposal we have set forth, they are still employees of the employee leasing company and would not lose their seniority and would not lose their benefits, and to me that is a very, very key area, both not only in pension plans, which we know is important, but in health care, disability, and so forth.

Mr. CARDIN. Thank you, Mr. Selter. Thank you, Mr. Chairman.

Mr. HOAGLAND. Any other questions from the members? Seeing none, thank you, gentlemen, for your participation today. We will now invite panel two to take their places at the witness table. I would like to welcome to the committee John Heilman with the Disabled American Veterans, James Magill with the Veterans of Foreign Wars, Vester Hughes with the firm in Dallas, Hughes & Luce, Donald Houck for the National Association of Water Cos., and Herbert Schmidt with the Robert Mondavi Winery.

Gentlemen, I would ask each of you if you could keep your statements to 3 minutes. I think we need to ask to keep your oral comments to 3 minutes. We have five panels altogether to try to finish up today, and, of course, we will accept anything else that you want to submit in the record basically, and the more plain you can be in your explanation of these complex tax matters, the better.

Mr. Heilman, would you begin please.

STATEMENT OF JOHN F. HEILMAN, NATIONAL LEGISLATIVE DIRECTOR, DISABLED AMERICAN VETERANS

Mr. HEILMAN. Yes, sir, Mr. Chairman, thank you. I am here in support of H.R. 786, the bill which was introduced by Chairman Montgomery on which he testified earlier. In brief, a 1992 IRS opinion, which was in response to a question from the VA regarding the tax-exempt status of VA home loan guarantee debt waivers, put in jeopardy the long historic tax-exempt status of VA benefits and services. Our country has never taxed veterans benefits and services throughout its entire history, and this IRS opinion in 1992 put that into question.

Immediate discussions at that time with the Department of the Treasury resulted in them backing off somewhat and producing an official policy that did concede that debt waivers were not taxable, disability payments were not taxable, and in-kind services were not taxable. Yet Treasury said at that time that they intended to conduct a further review of all the VA benefit programs in terms of determining what the tax-exempt status was. Well, frankly, Mr. Chairman, that was not satisfactory to us, and as you are well aware, the statutory clarification of the tax-exempt status of these benefits was placed in H.R. 11 last year, approved by the Congress and unfortunately was vetoed by President Bush for reasons certainly not related to that provision. So we are simply seeking approval of this legislation that would clear up the confusion and concern that now confronts our Nation's disabled veterans and their

families, that their benefits continue to be tax exempt as they always have.

This measure has the support of the administration and has no revenue impact whatsoever, and we certainly urge your favorable consideration. Thank you.

Mr. HOAGLAND. Thank you, Mr. Heilman.

[The prepared statement follows:]

STATEMENT OF
JOHN F. HEILMAN
NATIONAL LEGISLATIVE DIRECTOR
DISABLED AMERICAN VETERANS
TO THE
SUBCOMMITTEE ON SELECT REVENUE MEASURES
OF THE
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
JUNE 17, 1993

MR. CHAIRMAN AND MEMBERS OF THE SUBCOMMITTEE:

Mr. Chairman, my name is John F. Heilman, and I am the National Legislative Director of the Disabled American Veterans (DAV). I am appearing before you today on behalf of the 1.2 million members of the DAV to express our strong support for H.R. 786, introduced by Congressman Montgomery on February 3, 1993. I would like to express our gratitude to Congressmen Gibbons and Montgomery for ensuring that this vitally important legislation was included in today's hearing.

H.R. 786 would reaffirm the long-standing tax policy that veterans' benefits are fully exempt from taxation. In recognition of the great sacrifices made by the nation's million of veterans, the tax exemption for veterans' benefits has long enjoyed broad, bipartisan support in both houses of Congress. The exemption is explicitly provided by relevant provisions of the Internal Revenue Code (the "Code") and Title 38 of the United States Code. Moreover, the Internal Revenue Service (IRS), in its general publications and in those dealing specifically with veterans' benefits, has repeatedly stated that such benefits are excludable from income.

Despite this, a letter of February 27, 1992 from an official of the IRS to the General Counsel of the Department of Veterans Affairs (VA) concluded that Section 134 of the Code required veterans to include certain VA home mortgage debt waivers in income. A July 2, 1992 Treasury Department letter to the Executive Director of the DAV corrected this interpretation, noting that such benefits were in fact exempt from tax under the Code. The letter stated further that disability-related payments, including all cost-of-living adjustments that have been made since 1986, and all in-kind payments provided by the VA as of September 9, 1986, were also exempt from tax.

Recognizing that the February, 1992 letter cast a continuing cloud over the tax treatment of benefits provided to our nation's veterans, Congress placed in H.R. 11, the Revenue Act of 1992, a provision (Section 7103) clarifying that all veterans' benefits administered by the Secretary of Veterans Affairs were exempt from tax, effective for years beginning after December 31, 1984. The provision was scored as being revenue neutral, as it simply reaffirmed the long-standing tax treatment of veterans' benefits. Unfortunately, President Bush vetoed the Revenue Act of 1992 for reasons unrelated to this much needed reaffirmation.

Congressman Montgomery, along with Congressmen Stump, Evans, Rowland, Slattery, Sangmeister, and Bishop, introduced H.R. 786 in the 103rd Congress to put an end to the uncertainty surrounding the taxation of veterans' benefits. The language of the bill is identical to the provision included in the Conference Report on the Revenue Act of 1992.

While H.R. 786 has no revenue impact, its enactment will impact the lives of veterans by putting this question to rest for good. The Treasury Department supports this clarification. On behalf of America's millions of veterans, I urge you to reaffirm the long-standing tax treatment of veterans' benefits by enacting H.R. 786 at the earliest possible opportunity.

I thank you for the opportunity to appear before you today, and I will be glad to answer any questions.

Mr. HOAGLAND. Mr. Magill.

STATEMENT OF JAMES N. MAGILL, DIRECTOR, NATIONAL LEGISLATIVE SERVICE, VETERANS OF FOREIGN WARS OF THE UNITED STATES

Mr. MAGILL. Thank you. On behalf of the members of the Veterans of Foreign Wars, I again wish to thank you for allowing us to appear before this subcommittee in support of H.R. 786. Inasmuch as Mr. Heilman has given you a history of this bill, I, too, will be extremely brief in my oral remarks. The same provision being considered here today, as you know, was contained in H.R. 11, the Revenue Act of 1992. This bill, again, passed both Houses of Congress only to be vetoed by the President.

As was the case last year, H.R. 786, in our opinion, is noncontroversial and is revenue neutral. Furthermore, it is our conviction that it has never been the intent of Congress to tax the hard-earned benefits earned by our Nation's veterans. We believe that taxing veterans' benefits is a bad policy and is contrary to congressional intent. We ask that you report this bill to the full committee and then send it to the full House. This concludes my statement. I will be happy to answer any questions you may have.

[The prepared statement follows:]

VETERANS OF FOREIGN WARS OF THE UNITED STATES

OFFICE OF THE DIRECTOR

STATEMENT OF

JAMES N. MAGILL, DIRECTOR
NATIONAL LEGISLATIVE SERVICE
VETERANS OF FOREIGN WARS OF THE UNITED STATES

BEFORE THE

SUBCOMMITTEE ON SELECT REVENUE MEASURES
COMMITTEE ON WAYS AND MEANS
UNITED STATES HOUSE OF REPRESENTATIVES

WITH RESPECT TO

H.R. 786

WASHINGTON, D.C. JUNE 17, 1993

MR. CHAIRMAN AND MEMBERS OF THE SUBCOMMITTEE:

On behalf of the 2.2 million men and women of the Veterans of Foreign Wars of the United States, I wish to thank you for allowing us to appear before this distinguished subcommittee to testify in support of H.R. 786, a bill introduced by the Honorable G. V. "Sonny" Montgomery that would exempt veterans benefits administered by the Department of Veterans Affairs from taxation.

Mr. Chairman, in 1991 the General Counsel of the Department of Veterans Affairs requested from the Internal Revenue Service an opinion as to whether a veteran realizes taxable income when VA waives its right to collect a debt owed by the veteran under the VA's home loan guaranty program. Specifically, VA needed to know whether the IRS considers waiver of a VA debt a veteran benefit. In a February 27, 1992, letter of response to VA, the IRS acknowledged that a waiver of a VA debt was indeed a "veteran

benefit". However, the IRS also found that Section 134 (b) (1) of the IRS code stated that "Military Benefits" continued to be tax exempt after September 9, 1986, the date of enactment of the 1986 Tax Reform Act. Confusion arose as to whether "Veteran Benefits" and "Military Benefits" were synonymous. The two terms historically have not been interchangeable. Therefore, while military benefits such as pay and allowances, etc, that were provided by DoD were tax exempt, the tax exempt status of certain veteran benefits provided after 1986 were in question. While the IRS letter directly addresses only housing benefits, its reasoning could extend to tax many other benefits provided to veterans, such as cost-of-living adjustments.

Mr. Chairman, the same provision being considered here today was contained in H.R. 11, the "Revenue Act of 1992". As you know, this bill passed both Houses of Congress only to be vetoed by the president. As was the case last year, H.R. 786 is non-controversial in nature and is revenue neutral. Furthermore, it is our firm conviction that it has never been the intent of congress to tax the hard earned benefits a grateful nation has bestowed on her defenders.

Mr. Chairman, we believe that taxing veterans benefits is bad policy and is contrary to congressional intent. We ask that you report out and send to the full House, H.R. 786. We commend Mr. Montgomery for introducing this legislation and we commend you, Mr. Chairman, for holding this hearing on such an important piece of legislation.

This concludes my statement. I will be happy to answer any questions you may have.

Mr. HOAGLAND. Mr. Hughes.

STATEMENT OF VESTER T. HUGHES, JR., PARTNER, HUGHES & LUCE, DALLAS, TEX.

Mr. HUGHES. Congress has long recognized that it is in the public interest to encourage employee ownership of the corporations for which the employees work. This policy took root back in 1938 with deductions allowed for pension plans, and then it was expanded ultimately through stock bonus plans, and finally employee stock ownership plans. The general format of this plan, of course, has been the deductibility of contributions by the employer company and the taxation of distributions when ultimately made to the employees.

Unfortunately, while employee ownership has been encouraged in this form in the income tax law, there has never been a comparable tax provision in the estate tax law. Although many estate tax provisions allowing deductions for an estate—such as for executors fees and the cost of operating the estate—are comparable to the income tax deductions. There are no such comparable deductions allowed for a bequest of nonpublicly-traded stock to an ESOP.

H.R. 1807 attempts to rectify this problem in certain limited circumstances. The immediate stimulus for H.R. 1807 was the wishes of Charles A. Sammons who desired to transfer the significant ownership of a company called Sammons Enterprises to an ESOP for the benefit of his employees. A provision of this kind was considered by Congress, and passed by the Senate back in 1984, but was not enacted into law. The object of the legislation is to have a transfer from a charitable remainder trust to an ESOP at the termination of the charitable remainder trust be a proper tax distribution for a charitable remainder trust.

There are some 3,300 employees of this company; 2,700 of them are eligible for the ESOP, and they are scattered throughout the United States. There are many protections that are built into the bill, including the prohibition of allocations of transferred stock by the ESOP to family members of the decedent and a limitation of annual allocations to employees. I think part of the reason the Senate did not become law in 1984 may have been the absence of these protections. Moreover, this bill cannot be used for the benefit of substantial owners of the company. Rather, it is for employee ownership—those who help make the company function.

We believe this is in accordance with congressional policy in the income tax area and is appropriate for the estate tax area. I would like to file the formal presentation that has been made and would be happy to try to answer any questions that the subcommittee may have with respect to H.R. 1807.

Mr. HOAGLAND. Without objection, it is so ordered.

Mr. HUGHES. Thank you.

[The prepared statement follows:]

STATEMENT OF VESTER T. HUGHES, JR.
HUGHES & LUCE, DALLAS, TEX.

I. Background of the Problem.

Congress has long recognized that employee stock ownership should be encouraged. As early as 1938, Congress allowed a deduction for contributions to a trust to pay employee pensions. Congress later made clear that employer securities were proper investments for profit-sharing and pension plans, and added stock bonus plans to the list of tax-qualified retirement plans. Ultimately, the employee stock ownership plan or "ESOP" evolved. Congress wisely provided that the employer receives an income tax deduction for contributions to such plans and that the employee is not currently taxed either on the value of such contributions or on any increase in value until the plan actually makes distributions to the employee.

Unfortunately, the estate tax treatment of contributions to an ESOP has not been made consistent with the income tax treatment described above. Individuals who bequeath employer securities to ESOPs suffer adverse estate tax consequences because no estate tax deduction is available for such contributions.

Our proposal, which constitutes only a partial remedy of this inconsistency, is a generic one. However, it is prompted by the case of an individual who wanted to leave the bulk of his estate for the ultimate benefit of his employees. Mr. Charles A. Sammons wanted to leave stock of Sammons Enterprises, Inc. to an ESOP which currently has over 2,700 employees-participants. Mr. Sammons' desire is particularly commendable in that none of these employees are related to Mr. Sammons. Moreover, none of these employees own (other than through their participation in the ESOP) any stock of Sammons Enterprises, Inc. Thus, the direct beneficiary of Mr. Sammons' generosity is an ESOP in the classical sense. It is clear that Mr. Sammons' intent was to benefit only his employees.

However, because contributions to an ESOP are not deductible for federal estate tax purposes, Mr. Sammons left this stock to a trust. Under that trust, the stock will pass to the ESOP and/or to various named charities upon termination of a life estate. The trust provides that no stock may pass to the ESOP if such ESOP is not a permissible beneficiary of a charitable remainder trust at the time of the distribution.

As the law currently stands, and if it is not changed, the trust will be forced to distribute the stock to the various named charities because ESOPs are not currently permissible beneficiaries of charitable remainder trusts. H.R. 1807, however, would remedy this and allow Mr. Sammons' desired purposes in creating the trust to be fulfilled.

Furthermore, although it is true that H.R. 1807 is prompted by the Sammons situation, I believe that this provision would appeal to, and could promote employee ownership of, a number of closely-held companies. I have contacted a number of ESOP practitioners around the country and have been assured that they and their estate planners will make their clients aware of this opportunity if the legislation is enacted. Moreover, I am told that a Michigan industrial supply company and a Texas country club management company are actively considering using it, if enacted, and that several other companies have more than a casual interest in its passage.

II. Previous Attempts at Solution.

In 1984, the Senate adopted a provision, somewhat similar to H.R. 1807, which would have allowed a charitable deduction for the bequest of employer securities to an ESOP. There were

problems with the Senate bill, in that it had no provision prohibiting the use of the ESOP as an estate planning vehicle for transferring stock to descendants of the company's owners and, in addition, could have caused employee-beneficiaries of the ESOP to become "instant millionaires." These problems have been solved in H.R. 1807 by its exclusion of family members and its annual limitation on allocations. Nonetheless, the Senate bill is illuminating, and indicates a long-term interest in estate transfers to ESOPs. A copy of the 1984 statutory language and the Senate Finance Committee report is attached hereto as Exhibit A for your convenience.

III. Solution (H.R. 1807).

On April 22, 1993, Congressman Andrews introduced a bill (H.R. 1807) that would make employee stock ownership plans permissible beneficiaries of charitable remainder trusts in certain limited circumstances. Under H.R. 1807, the securities must be left by a decedent to a charitable remainder trust, which then might be used to pass the securities to an ESOP. Once distributed to the ESOP, no allocation of such securities can be made to participants who are related to the donor or who own more than 5% of the stock of the issuing corporation. As a result, the proposed legislation cannot be manipulated to move assets to family members or significant shareholders. Nor could it become a tool for the financiers of Wall Street.

The Joint Committee on Taxation has determined that the effect of a predecessor to H.R. 1807 (H.R. 3485, as introduced by Congressman Andrews on October 3, 1991 in the 102nd Congress) would be to "reduce fiscal year Federal budget receipts by less than $1 million annually." A copy of the Joint Committee's letter to Congressman Andrews is attached hereto as Exhibit B. Thus, under the Joint Committee's evaluation, only a de minimis revenue effect would result. Furthermore, a strong case can be made that the effect of H.R. 1807 would be revenue positive.

It is very unlikely that taxpayers will establish a charitable trust to benefit an ESOP unless they, like Mr. Sammons, would otherwise leave such assets to charities, but such situations are not all that uncommon. In my practice, I have seen several among my clients, and more outside my own practice, who would like, or would have liked, to make an estate transfer to an ESOP but instead opted for a charitable donation due to the absence of legislation like H.R. 1807. Thus, H.R. 1807 will keep assets in the taxable sector that would otherwise move to the tax-exempt sector. As you know, the value of assets donated to charities leaves the tax revenue stream. In contrast, the value of assets which pass to an ESOP will ultimately be subject to taxation when the assets are distributed to the employees. In any event, any negligible revenue effects of this bill are well worth the added employee ownership that H.R. 1807 makes possible.

It is important to keep in mind that H.R. 1807 will make no tax difference in the Sammons' situation. Mr. Sammons' stock will go to charities if it does not go to the ESOP. However, those associated with Mr. Sammons obviously want to carry out his wishes. Sammons Enterprises, Inc. has over 2,700 ESOP participants who are located in 28 states. See Exhibit C, attached hereto, for a list of those states and the number of such employees located in each state. These employees obviously would like to see Mr. Sammons' stock pass to the ESOP.

In conclusion, when a taxpayer chooses to leave stock to his employees, the philosophy of an estate tax deduction is supported strongly by the same philosophy that lies behind the income tax deduction -- that employee ownership is a good thing. Thus, H.R. 1807 accords with the basic purposes of ESOPs and presents an opportunity for sound legislative policy.

Mr. HOAGLAND. Thank you, Mr. Hughes. Let me explain the unfortunate logistics. We have been notified of a quorum call followed by a 5-minute vote, so I think we will have no alternative but to suspend for 10 minutes or so or 15 while we go do those two things. In the meantime, I wonder if we might take questions, any questions of Mr. Magill and Mr. Heilman right now on the veterans bill, the veterans procedural changes that they are arguing for so that we could at least let the two of them go back to their offices before we have to take a break, and I do have one question here of both of you, and that is the bill H.R. 786 would exclude from income any allowance or benefit administered by the Secretary of Veterans Affairs.

Now, last year the Treasury Department stated in a letter that general veterans benefits are excludable from income. Now, as I understand it, H.R. 786 goes beyond the position taken by Treasury, and I am wondering what your reasons are for requesting that broader relief.

Mr. HEILMAN. Mr. Chairman, I think you are referring to the July 1992 letter by Treasury where they backed off, as I indicated, from their initial assessment that debt waivers were taxable. In that letter they conceded that debt waivers were not taxable, that disability payments were not taxable, and that in-kind services presumably something like VA medical care were not taxable, but they did indicate in that letter that they were going to conduct a review to determine, to look at all the VA benefits and services other than the three that they mention in their letter and decide just what was or wasn't taxable. That left in question educational benefits, for example, death benefits, for example, and as I have indicated, these benefits have never in our 200-plus year history been subject to taxation, so we don't want to leave our tax status at the administrative whim of current or future attorneys in IRS.

Current law both in title 38 and title 26 indicates these benefits are tax exempt, and it was just this tortured IRS opinion that put the question on the table.

Mr. HOAGLAND. Thank you. Mr. Magill, do you have any comments?

Mr. MAGILL. I would only add one thing, that it was also the IRS's determination that any modifications or changes to veterans benefits after 1986 would be taxed. This certainly would include any cost of living adjustments that would be made. Again, as we have both said, we have felt it has never been the intent of Congress to tax veterans benefits, and what we are asking now is that it just be codified into law. Thank you.

Mr. HOAGLAND. Mr. Sundquist, do you wish to be recognized with respect to this?

Mr. SUNDQUIST. Thank you, Mr. Chairman. I would like to ask unanimous consent to put a statement in the record in support of H.R. 786. I am a cosponsor, and would hope that this bill can be considered by the committee at the earliest possible date, se we can clarify this issue once and for all.

[The statement follows:]

STATEMENT OF DON SUNDQUIST

Mr. Chairman, I want to commend Representative Montgomery for introducing his bill, H.R. 786, which would clarify that veterans' benefits should not be taxed. This would put to rest any uncertainty, as occurred in 1991, when an IRS opinion called into question the longstanding, nontaxable status of veterans benefits.

Mr. Chairman, this bill has no revenue loss associated with it, is noncontroversial and passed the house last year as part of H.R. 11.

If this provision cannot be moved quickly as part of a larger bill, I would recommend that it be allowed to go to the floor on the suspension calendar.

Thank you, Mr. Chairman.

Mr. SUNDQUIST. I will yield to my friend for a unanimous consent request.

Mr. CAMP. Thank you. I also would like to associate myself with Mr. Sundquist's remarks that we should look at this as quickly as possible and would ask unanimous consent to place a statement in the record in support of H.R. 786.

[The statement follows:]

DAVE CAMP
4TH DISTRICT, MICHIGAN

MEMBER
COMMITTEE ON
WAYS AND MEANS

SUBCOMMITTEE ON
SELECT REVENUE MEASURES

SUBCOMMITTEE ON
HUMAN RESOURCES

Congress of the United States
House of Representatives
Washington, DC 20515-2204

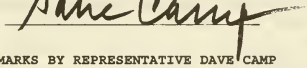
137 CANNON BUILDING
WASHINGTON, D C 20515-2204
(202) 225-3561
FAX (202) 225-9679

DISTRICT OFFICES

135 ASHMAN
MIDLAND, MI 48640
(517) 631-2552
FAX (517) 631-6271

3508 WEST HOUGHTON LAKE DRIVE
SUITE 1
HOUGHTON LAKE, MI 48629
(517) 366-4922

308 WEST MAIN ST
OWOSSO, MI 48867
(517) 723-6759
TOLL FREE 1-800-342-2455



REMARKS BY REPRESENTATIVE DAVE CAMP
OF MICHIGAN

COMMITTEE ON WAYS AND MEANS

ON H.R. 786, TAX FAIRNESS FOR VETERANS

June 17, 1993

MR. CHAIRMAN. I would like to add my voice in support of H.R. 786, legislation sponsored by Veterans' Affairs Committee Chairman Montgomery, clarifying the current and long-held policy that veterans' benefits are exempt from taxation.

H.R. 786 sends the simple message to those who have sacrificed so much for our freedoms -- our veterans -- that we must continue this policy and not forget their deeds of courage and honor.

The purpose of this bill is to ensure that veterans' benefits are not taxed as income. This is current practice. However, due to a poorly conceived 1992 Internal Revenue Service General Counsel Opinion, the policy of exempting certain benefits has been called into question. With this in mind, it is more important than ever to enact this legislation and ensure that the benefits earned by our Nation's veterans are protected.

Mr. Chairman, I want to include for the Committee Record that H.R. 786 is supported by both the previous and current Administrations and has no impact on revenues. Out of concern and support for America's veterans I am pleased to cosponsor H.R. 786 and I call on each of my colleagues in the Committee and full House of Representatives to join Chairman Montgomery, Mr. Sundquist and myself in support of this worthy legislation.

THIS STATIONERY PRINTED ON RECYCLED PAPER

Mr. HOAGLAND. With respect to both statements, without objection, it is so ordered. Any other questions of Mr. Magill or Mr. Heilman? Does anyone have any questions of Mr. Hughes? All right. Seeing none, perhaps the three of you may consider yourself released, and we will suspend the hearing now for 15 minutes or so until we complete both of these votes. We will be back shortly.

[Recess.]

Mr. HOAGLAND. We will reconvene the hearing. Mr. Schmidt and Mr. Houck, if you would resume your seats, please. Gentlemen, I sort of hate to ask you to give your testimony before more members have returned. Why don't we just stay at ease for a minute or two until a couple of our members return and they will have the benefit of your thoughts.

Mr. HOUCK. Thank you.

Mr. HOAGLAND. OK, Mr. Houck.

STATEMENT OF DONALD L. HOUCK, MEMBER, BOARD OF DIRECTORS, NATIONAL ASSOCIATION OF WATER COS., AND PRESIDENT AND CHIEF EXECUTIVE OFFICER, CALIFORNIA WATER SERVICE CO., SAN JOSE, CALIF.

Mr. HOUCK. Thank you, Mr. Chairman. My name is Don Houck. I am president and CEO of California Water Service Co., an investor-owned water utility located in San Jose, Calif. I am also a member of the board of directors of the National Association of Water Cos. The association represents the Nation's investor-owned water utilities, which provide drinking water to more than 22 million Americans in 41 States. In California, investor-owned water suppliers provide drinking water to 20 percent of the urban population.

Investor-owned utilities, big or small, have one thing in common. We are being crippled by taxes on contributions in aid of construction, commonly referred to as CIAC. Passage of H.R. 846 will help to heal the damage done by the CIAC tax not only to our industry but also to our customers, to the cost of housing, and to the environment.

Historically CIAC was not included in the gross income of an investor-owned utility and therefore was not subject to Federal income tax. In 1986, changes to section 118(b) of the Internal Revenue Code subjected CIAC to tax as gross income. Consequently, contributed property is now eligible for tax benefits, including tax depreciation available under the Internal Revenue Code. Because of refunds and tax depreciation, the aggregate tax impact to the Federal Government is quite small, but because the new customer pays the tax up front, a disincentive to private capital investment is created which has far-reaching effects.

Generally, State utility regulatory bodies permit utilities to receive a reimbursement for the taxes paid on the contribution, plus the tax on this tax. This gross-up can add as much as 70 percent to the developer's cost of the contribution. In California, because the tax payment is shared between the new customers and the larger utilities, a $100,000 main extension costs an additional $33,000 from the developer plus $20,000 from the utility, which is passed on to the utility's customers through higher rates.

When a gross up is charged up front, several things may occur. One, a housing development may be reduced in size or abandoned

completely because of the added costs. Two, the cost could be passed on to the new home buyers or, three, the new customer will seek to avoid the tax by, one, either setting up their own utility or; two, connecting into a municipal system which does not pay taxes.

A water utility near Sacramento currently serving a population of approximately 20,000 people is presently negotiating a sale of the system to a county water district. The reason? The area is set for substantial growth but developers have been so vocal in their protest against the unfair CIAC tax the county is now looking at acquiring the system. A tax law that puts a taxpaying entity out of business in favor of a nontaxpaying one is not, I think, what anyone had in mind.

The Joint Tax Committee has estimated repeal of the tax will cost $108 million over 5 years. However, because of changes in depreciation practices contained in the bill, repeal of the tax will end up raising an additional $140 million over the same period of time, resulting in a $32 million increase in revenues for the Federal Government in the short term. In the long term it will mean untold millions in additional tax revenues as the repeal of the CIAC tax will provide growth opportunities for a taxpaying industry. I urge the subcommittee to adopt H.R. 846 and I am grateful for the opportunity to testify before you today.

Mr. HOAGLAND. Thank you, Mr. Houck.

[The prepared statement and attachments follow:]

STATEMENT OF DONALD L. HOUCK, PRESIDENT AND CEO OF CALIFORNIA WATER SERVICE COMPANY, ON BEHALF OF THE NATIONAL ASSOCIATION OF WATER COMPANIES

Good morning Mr. Chairman and members of the Subcommittee. My name is Don Houck. I am President and Chief Executive Officer of California Water Service Company, an investor-owned water utility located in San Jose, California. I am also a member of the Board of Directors of the National Association of Water Companies.

The National Association of Water Companies (NAWC) is the trade association representing the nation's investor-owned water utilities. Its 360 members in 41 states provide safe, reliable drinking water to over 22 million Americans every day. However, this statistic does not tell the whole story. In many states, investor-owned water utilities are a significant presence. For example, in California, investor-owned water suppliers provide drinking water to 20 percent of the urban population. Our companies employ a combined work force in excess of 15,000 nationwide. In 1991, these companies had operating revenues of $2.3 billion and gross utility plant of $9 billion.

Our companies run the gamut from large, publicly traded ones like California Water Service Company (description of service area attached) to small, family owned operations like the Elk Grove Water Works just outside Sacramento which has been in the same family for nearly 100 years. But all of us - big or small - have one thing in common, we are crippled by CIAC!

Passage of H.R. 846, will help to heal the damage done by the CIAC tax. Not only to water and wastewater utilities, but to our customers, housing prices and the environment. I will explain each of these effects in turn, but first an explanation of the CIAC tax is in order.

THE TAX ON CONTRIBUTIONS IN AID OF CONSTRUCTION AND HOW IT WORKS

Water suppliers, like all utilities, are capital intensive industries. Historically, they have received the capital for the construction of a utility extension directly from the customer (typically a developer, although it can be a public school, a government agency or an individual homeowner). The customer contributes this property, or a cash equivalent, to the utility. In this way, utilities can eliminate the need to spread additional borrowing costs, in the form of rate increases, to the existing body of customers and protect them from business risk.

Prior to enactment of the Tax Reform Act of 1986, CIAC was not considered as gross income of an investor-owned utility and therefore was not subject to federal income tax. In addition, utilities could not earn on CIAC nor could they take tax depreciation or investment tax credits on CIAC.

The '86 Act repealed section 118(b) of the Internal Revenue Code and thus subjected CIAC to tax as gross income. Property received as a contribution is now eligible for any tax benefit, including tax depreciation, available under the Internal Revenue Code. However, even with this change in the tax code, water utilities and public utility commissions (PUCs) still do not consider CIAC as income, but rather capital and PUCs do not permit utilities to benefit from the CIAC.

EFFECT OF CIAC TAX ON CUSTOMERS AND HOUSING PRICES

Because of refunds and depreciation, over the life of a contributed asset the aggregate tax impact to the federal government is quite small. But because the customers of investor-owned water utilities pay the tax upfront, a disincentive to private capital investment is created which has far reaching effects.

Generally, PUCs permit utilities to receive a reimbursement for the taxes paid on the contribution plus the tax on this tax. This "gross-up" can add as much as 70 percent to the customer's cost of

the contribution.[1] In other words, a contribution of water mains valued at $100,000 would cost $170,000. The PUC directs these additional costs to be either passed-on upfront to the new customer, or through rates to the existing customer base.

When utilities pass on the tax (a tax which is grossed up), it has a detrimental effect on their business, housing costs and the environment, particularly where water utilities are concerned. If a gross-up is charged upfront, several things may occur:

a. the prospective customer may reduce the size of the project or abandon it completely because of the added cost, which has a negative impact on employment and the economy;

b. the cost will be passed on to new home buyers. The National Association of Home Builders has estimated the CIAC tax contributes as much as $2000 to the price of a new home. **The CIAC tax contributes to higher housing costs**;

c. the prospective customer will avoid the tax by:

1. setting up their own utility;

2. constructing individual wells and septic tanks - an alternative not as environmentally sound as community systems;

3. connect into a municipal system which does not pay taxes.

These last three alternatives are only practical for water and sewage service. In many cases, because of their much larger size, a gas or electric utility can pay for the facilities required by the new development making CIAC unnecessary. In addition, there seldom are alternatives to acquiring electric or gas from the local utility, since it is not economically feasible to develop an independent gas or electric supply. It is a relatively simple proposition to drill a well and establish an independent, frequently non-viable water supply.

In some cases the CIAC tax is spread among existing customers, exactly what CIAC is intended to avoid. This can mean higher utility rates for customers of investor-owned water utilities compared to customers of municipal systems. Higher utility rates for the customers of investor-owned utilities can fuel cries for condemnation, to which investor-owned water utilities are particularly vulnerable. Under a condemnation, all tax revenues would be lost.

This is not an idle concern. Earlier I mentioned the Elk Grove Water Company. It currently serves a population of about 20,000. The owners are currently negotiating for the sale of the system to the county water district. The reason: the area is set for substantial growth but developers are complaining so vehemently about the CIAC tax that the County may acquire the system.

Attached you will find election propaganda used to promote a successful referendum last November for the acquisition of an investor-owned wastewater utility. Note that the cost of CIAC is one of the top reasons cited for acquiring the system.

I want to make it clear to the Subcommittee that "customers" are not just homes and businesses, they are any facility that needs water. This includes government facilities, churches, hospitals,

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[1] In California, because the gross-up calculation is made on a net present value basis and includes state income tax, the gross-up percentage averages about 33 percent. Still a very significant cost increase. The remaining amount of the tax is included in the company's rate base and thus gets passed on to existing customers.

prisons and schools. In such cases, the cost of the CIAC tax can sometimes be measured in non-economic terms.

One recent example of this is the experience of an elementary school in Pennsylvania. The state health department ordered the school off of its well after it was found to be contaminated. The school is in the franchise of one of our member companies and contracted with it for service. Because of the additional cost imposed on the school by the CIAC tax, it was forced to forego the purchase of textbooks.

ENVIRONMENTAL EFFECTS OF THE CIAC TAX

The best way to improve compliance with the Safe Drinking Water Act is to consolidate some of the nearly 60,000 water systems supplying drinking water. Another is to discourage the formation of new, small systems. Investor-owned water utilities are in a unique position to undertake consolidation through acquisitions and regional management. We are often asked, and sometimes forced, to do so by state health departments and PUCs.

Small water systems frequently pose problems for both EPA and the states. According to EPA, in fiscal year 1992, more than 90 percent of Safe Drinking Water Act violations were made by systems serving less than 3,300 individuals. Even more telling, 91 percent of systems with serious, frequent or persistent violations serve less than 3,300.

But CIAC tax frustrates this environmental policy goal. As described above, the CIAC tax acts as an incentive to the construction of additional small systems in order to avoid the tax. It also encourages the installation of septic systems which can pose significant environmental threats to the local water supply. To make matters worse, a recent private letter ruling on the CIAC tax actually created a disincentive for the consolidation of water systems.

IRS letter ruling #9125009, released March 19, 1991, can make acquisitions of systems uneconomical. This letter ruling states the difference between the acquisition price and replacement price of a water system is CIAC! It makes many arm's length acquisitions uneconomical even when they are justified to protect the public health. And while a private letter ruling issued early this year, #9314023, narrowed the earlier ruling it still stands. The single most important step Congress can take to promote consolidation of water systems is repeal of the CIAC tax. With this one step, Congress will eliminate an incentive for the construction of new, small water systems and render the letter rulings moot.

One final environmental effect of the CIAC tax is less obvious, but no less important. It makes less money available for environmental programs. For example, last year, my company obtained State superfund money to pay half the cost of installing a treatment facility at a contaminated well site. In addition to the $80,000 cost of installing the facility, the State of California was required to pay an additional $26,500 in CIAC taxes. This situation is not unique in either California or the nation.

H.R. 846

The NAWC strongly supports the enactment of H.R. 846 this year. H.R. 846 restores the historical treatment of CIAC to water and wastewater utilities. Repeal of the CIAC is also supported by the National Association of Home Builders and the National Association of Regulatory Utility Commissioners. H.R. 846 is sponsored by Congressmen Bob Matsui, Andy Jacobs, ten other members of the Committee and 57 members of the House.

There should be no controversy surrounding repeal of this tax. Water utilities will receive no tax benefit from repeal of the tax other than the time value of money. And according to the Joint Committee on Taxation, passage of H.R. 846 will actually raise

revenue for the federal government.

The Joint Committee has estimated repeal of the tax will cost $108 million over five years. H.R. 846 also contains a provision extending the depreciable life of water utility property placed in service after enactment of the CIAC tax repeal from 20 to 25 years using straight-line depreciation rather than 150 percent declining balance. JCT has estimated this will raise $140 million over five years.

In the short term, this will net $32 million for the treasury. Over the long-term, it will mean untold millions in additional tax revenues as repeal of the CIAC tax will not stifle the growth of a tax-paying industry.

After long, serious and contentious deliberations, our industry agreed to offer up a revenue offset that gores our own ox. We offer it only as a way to make up the revenue the JCT estimates will be lost with repeal of the CIAC tax. This offset is inseparable from the CIAC tax repeal and should be so treated by the Congress. We did not pour over the tax code in search of an esoteric loophole to close. Rather our industry is financing repeal with an increase in our own taxes. For some of our members, it represents real pain, but pain they are willing to bare if it means the CIAC tax will be repealed. I implore the Committee to respect this link and preserve it throughout the legislative process.

CONCLUSION

I urge the Subcommittee to adopt H.R. 846 and restore the historical exemption of contributions in aid of construction from gross income. Capital contributions should be treated as capital, not income. The tax on CIAC is not a tax on utilities, it is a tax on their customers. It increases the price of new homes, leads to the development of environmentally unsound water and sewage facilities and reduces the tax base for all levels of government.

I am grateful for this opportunity to testify before you today and am happy to answer any questions you may have.

CALIFORNIA WATER SERVICE COMPANY SERVES 1.25 MILLION CUSTOMERS IN THE FOLLOWING COMMUNITIES:

Atherton
Bakersfield
Broadmoor
Chico
Colma
Commerce
Cupertino
Dixon
East Los Angeles
Hamilton City
Hermosa Beach
King City
Livermore
Lomita
Los Altos
Los Altos Hills
Marysville
Menlo Park
Montebello
Mountain View
Oroville
Palos Verdes Estates
Portola Valley
Rancho Palos Verdes
Redondo Beach
Rolling Hills
Rolling Hills Estates
Salinas
San Carlos
San Mateo
Selma
South San Francisco
Stockton
Sunnyvale
Torrance
Vernon
Visalia
Westlake
Willows
Woodside

WHY I WILL VOTE

YES

FOR SEWER ACQUISITION BONDS

- The bonds will be paid for by existing user fees. There will be no tax increases.
- I will save money on my monthly sewer bill.
- Profits that now go out of state will belong to Bourbonnais citizens.
- The Federal Government charges a huge development tax on sewers if they are privately owned. It's a hidden tax I can vote away.
- Rates tend to be higher in communities with privately owned utilities than in communities with citizen owned utilities.
- If any "surprises" should develop relative to improvements needed due to new EPA regulations or other unknowns, any new costs will be borne by the users of the system through their monthly sewer bills, regardless of who owns the system.
- A sewer system is a key to economic growth. If the citizens owned the sewer system, the Village would be eligible for State and Federal grants, which are not available to Consumers Water Company.

WHY A VILLAGE-OWNED

SEWER SYSTEM?

There are a number of reasons why Bourbonnais citizens would want to own their sewer system. They are:

1. To provide the lowest cost service to Bourbonnais citizens.
2. To provide local control of an essential public service.
3. To provide local control of system improvements.
4. To provide a positive impact on overall economic development efforts.

WILL TAXES PAY FOR THE BONDS?

NO. Tax dollars can never be used to pay for the bonds. Existing sewer charges will pay for these bonds.

VILLAGE OF BOURBONNAIS SEWER BONDS

IT'S YOUR MONEY

You can keep more of it!

By voting YES on issuing bonds to purchase your Village sewer system.

How much will your monthly bill be reduced?

Sewer service rates will go down 7% on the day the sewer system is purchased.

Passage of this referendum will not affect taxes.

Sponsored by Citizens Committee for Lower Sewer Rates

HOW CAN CITY OWNERSHIP

CREATE LOWER RATES?

(A) Profits that now go out of state will belong to Bourbonnais citizens.

(B) Federal taxes will be eliminated.

The 1987 Federal Tax Act created massive cost increases to private sewer company customers by calling development costs income to private sewer utilities. The net result--we will pay a 34% tax or about $350 per new house built until the sewer system is owned by the Village. This tax does not apply if the sewer system is Village owned.

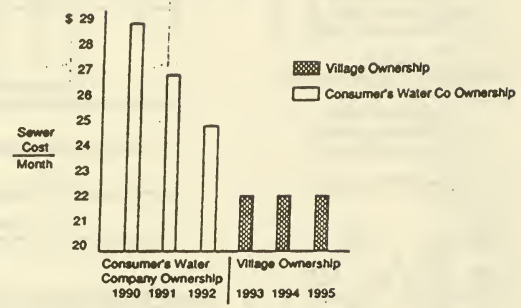
(C) The Village can control the Kankakee Metro treatment charges.

The Kankakee Metro treatment charges to Bourbonnais citizens have exceeded $1,000,000 per year in the past. The Village through proper structuring of the Metro payments and costs will be able to reduce these costs to less than $725,000 immediately and potentially more in the future.

(D) The Village's interest rate on debt is less than Consumers Water Company's.

Interest rates are currently the lowest they have been in 29 years. We can lock in a 20 year fixed bond cost now, and Bourbonnais residents will benefit from today's low interest rates for the next 20 years.

SEWER SERVICE COSTS



Village ownership guarantees you the rates that will be set for 1993 , 1994 and 1995. Consumers Water Company will charge whatever they are allowed and can pass through to you. The choice is simple.

VOTE YES FOR THE $3,200,000 BOND ISSUE

TO BUY YOUR SEWER SYSTEM

Mr. HOAGLAND. Mr. Schmidt.

STATEMENT OF HERBERT SCHMIDT, VICE PRESIDENT, GOVERNMENT AND COMMUNITY RELATIONS, ROBERT MONDAVI WINERY, OAKVILLE, CALIF., ON BEHALF OF AMERICAN VINTNERS ASSOCIATION

Mr. SCHMIDT. Mr. Chairman and members of the subcommittee, my name is Herb Schmidt. I am vice president of Robert Mondavi Winery of Oakville, Calif. I am here today on behalf of the American Vintners Association, of which I am a member of the board, as well as five vintners and wineries from all over the United States. Additionally, Mr. Greg Brady of our staff, a tax specialist, has joined us for any technical questions that you may have about the amendment which we have proposed.

We appreciate the opportunity and we thank you for that opportunity to submit this testimony concerning the proposal which would clarify the application of the uniform capitalization rules to certain agricultural crop losses. We would also like to express our strong support for Congressman Kopetski's proposal to repeal the special occupational tax, which will be the subject of a hearing before this subcommittee on June 22, 1993.

The proposed amendment which is the subject of today's hearing would allow a taxpayer to currently deduct costs incurred for replanting necessitated by casualty damage. This includes both weather and pest-related damage for any edible crop for human consumption. By clarifying the existing law, this amendment would greatly benefit all growers of edible crops. Specifically, this provision would amend section 263A of the code by clarifying the current broad exemption from the uniform capitalization rules for expenses relating to agricultural casualty losses.

On its face, the current exemption allows farming businesses which are forced to replant fields due to a naturally caused disaster to avoid the section 263A rules for all costs relating to such disasters. The clarification would ensure that the original intent of Congress is implemented. Recently the IRS has begun to give the provision an extremely narrow interpretation. Under this interpretation the expenses required for replanting after natural disasters is limited to preproductive period costs. Such an interpretation thwarts the intent of Congress and impedes the efficient restoration of damaged farmlands, the central purpose of this provision.

Senator Bob Packwood, the Chairman of the Finance Committee, when section 263A was adopted in 1986, publicly declared his interpretation of the provision in a colloquy with then Chairman Lloyd Bentsen last September. In this colloquy, Senator Bentsen stated that the casualty exception to 263A is intended to apply to all costs otherwise subject to 263A or section 263 if 263A does not apply. He also stated that the provision is intended to cover all replanting costs, not just preproductive costs.

In light of the foregoing, the IRS position is unfathomable. However, the conflict can be easily rectified by clarifying section 263A with a simple rule. This rule would apply the exemption to all preproductive period costs and 80 percent of all other costs of a taxpayer incurred by replanting his plants. To avoid a double deduction, the proposed amendment should also amend section 165 by

inserting new language which bars section 165 deductions where the costs of replanting are deducted under section 263A.

The provision is critical for the wine industry. Phylloxera is destroying grape vines throughout Oregon, Washington, and California. The insect cannot be combated by conventional pesticide methods, only by complete removal of the infested vineyards including irrigation equipment, drain tiles, and the trellising systems followed by fumigation and replanting of the root stalks resistant to the pest. This is very costly.

In my own company, Robert Mondavi Winery, we estimate the costs of replanting will be $21.2 million, not including the 3 to 4 years that we will lose because of lost production in those vineyards.

Frostkill is another serious problem affecting the wine-growing regions of New York, Pennsylvania, Ohio, Michigan, Missouri, and Arkansas. Frostkill leads to seriously weakened vines that become extremely susceptible to disease and infestation. For example, as a result of recent severe weather in Missouri, Stone Hill Winery, the largest winery in the State, has been forced to remove an entire vineyard. These costs are impacting the wine industry at a time when foreign competition is increasing. These costs could cause less fortunate winemakers to fail.

Finally, the U.S. Department of Agriculture has warned us that failure of grape growers to take effective action to protect themselves against the insects could lead to devastating consequences for vast areas of vineyards. If the IRS's current interpretation is not modified, the ability of grape growers to respond to the threat posed by the phylloxera infestation will be seriously impaired, thus harming winemakers and grape growers alike. I would like to emphasize that the proposed amendment would not provide an undue benefit to any growers. Instead, the provision would do little more than help ensure that these growers can regain the position in which they were prior to the casualty.

Mr. Chairman, on behalf of the American Vintners Association and the entire wine industry, I thank you and the entire subcommittee for holding this hearing on the proposed amendment. Again, thank you.

Mr. HOAGLAND. Well, thank you, Mr. Schmidt.

[The prepared statement follows:]

Testimony of

AMERICAN VINTNERS ASSOCIATION

CHATEAU GRAND TRAVERSE VINEYARDS
TRAVERSE CITY, MI
LAKEWOOD VINEYARDS
WATKINS GLEN, NY
ROBERT MONDAVI WINERY
OAKVILLE, CA
STONE HILL WINERY
HERMANN, MO
TREFETHEN VINEYARD
NAPA, CA

by Herbert Schmidt
Vice-President, Robert Mondavi Winery

Before the

SUBCOMMITTEE ON SELECT REVENUE MEASURES
COMMITTEE ON WAYS AND MEANS
UNITED STATES HOUSE OF REPRESENTATIVES

June 17, 1993

Introduction

Chairman Rangel and Members of the Subcommittee on Select Revenue Measures, my name is Herbert Schmidt, and I am a Vice-President of the Robert Mondavi Winery ("Robert Mondavi") of Oakville, California. I am here today on behalf of the American Vintners Association, the national association of American wineries of which I am a Member of the Board, as well as the five vintners and wineries listed above from all over the U.S., including Robert Mondavi, my own company.

We appreciate the opportunity to submit testimony concerning a proposal which would clarify the application of the uniform capitalization rules to certain agricultural crop losses. We would also like to express our strong support for Congressman Kopetski's proposal to repeal the special occupational tax which will be the subject of a hearing before this Subcommittee on June 22, 1992.

In particular, the proposal which is the subject of today's hearing would allow current deductibility of the costs incurred for replanting necessitated by casualty damage. The types of damage covered by this provision include both weather and pest related damage for any edible crop for human consumption.

This provision would amend section 263A(d)(2)(A) of the Internal Revenue Code ("Code") by clarifying the Code's current broad exception from the uniform capitalization rules for expenses relating to agriculture casualty losses. On its face, the current exception allows farming businesses, which are forced to replant fields due to naturally-caused disasters (freezing temperatures, pests, casualty, and the like), to avoid the section 263A rules for all costs relating to such disasters. The IRS has recently been taking an overly restrictive position on this provision. The clarification would ensure that the original intent is implemented.

We provide below an explanation of why the IRS position is not only illogical but also clearly inconsistent with congressional intent. This is evident by an analysis of the legislative scheme and legislative history, which was explicitly clarified by the Chairman of the Finance Committee in 1992.

The Current Conflict of Interpretation

While the plain language of section 263A in its current form would seem to prevent any dispute as to its meaning, recently the Internal Revenue Service ("IRS") has begun to give the provision an extremely narrow interpretation. Under this interpretation, expenses required for replanting after natural disasters is limited to only preproductive period costs. Such an interpretation thwarts the intent of Congress, as evidenced by the plain meaning of the provision, and impedes the efficient restoration of damaged farmlands, the central purpose of this provision.

Specifically, the IRS is taking an overly restrictive view of section 263A(d)(2), insisting that: (1) section 263A is not all-inclusive and, therefore, a portion of the replanting costs should be capitalized under other code sections; and (2) the loss exemption under section 263A(d)(2) is very limited and applies only to preproductive costs.

We believe that this interpretation conflicts with congressional intent and the plain meaning of section 263A. First, the legislative history indicates that Congress intended section 263A to be the exclusive capitalization rule for farming businesses expenditures. Congress enacted section 263A as part of the Tax Reform Act of 1986 ("TRA") in response to its concern that different capitalization rules were being applied depending upon the nature and intended use of property. Section 263A provided a single, comprehensive set of capitalization rules. (See Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986 (May 4, 1987), at 508-509.)

Congress also intentionally applied the new capitalization rules to farming businesses. The Senate's version of the 1986 TRA provision exempted farming businesses from the new capitalization rules, but the conference agreement followed the House provision which applied the new rules to farming businesses. (See H.R. Conf. Rep. No. 99-841, 99th Cong., 2d Sess., vol. II, at 113-114 (1986).)

The legislative history also indicates that Congress intended that the agricultural casualty loss exemption of section 263A apply broadly to the deductibility of all replanting costs, through section 263A(d)(2)(A). When section 263A was enacted in 1986, Congress repealed the former casualty loss provision contained in section 278(c). Former section 278(c) had allowed a farming business to deduct replanting "amounts allowable as deductions (without regard to section 278)." However, reflecting a concern that section 278(c) was too narrowly drawn and restricted a farmer's ability to restore a vineyard to its original condition, Congress expanded the application of the loss provision when it enacted section 263A(d)(2)(A). Consistent with this belief that additional relief was needed, Congress modified the language of section 263A(d)(2) to exempt more broadly "any costs" associated with replanting under this code section. Moreover, the House report states that the loss exemption is for costs attributable to replanting, cultivation, maintenance, and development. This definition is much broader than merely costs incurred during the preproductive period. (See H.R. Conf. Rep. No. 99-841, at 113.)

Last September, a colloquy on the floor of the United States Senate between Senator Robert Packwood and then-Chairman Lloyd Bentsen also revealed the congressional intent with respect to section 263A. Senator Packwood's comments were particularly relevant because he was the Finance Committee Chairman in 1986, the year section 263A was enacted. In this colloquy, Senator Bentsen cited natural disasters like Hurricanes Andrew and Iniki, which destroyed crops in Florida and Hawaii, respectively, as well as the phylloxera infestation of Oregon, Washington, and

California. The Senator also noted that the costs of replanting and the resulting lost production could cost $1 billion in Napa and Sonoma counties alone, and that such costs could force some wineries into bankruptcy.

Senator Bentsen asked Senator Packwood whether Congress intended section 263A(d)(2)'s exception to apply to "all costs otherwise subject to the capitalization requirements in section 263A or section 263 if section 263A did not apply?" Senator Packwood responded:

> Yes; it is. The exception to section 263A contained in paragraph (d)(2) of that section is intended to apply to all costs otherwise subject to 263A, or section 263 if section 263A does not apply, incurred as a result of freezing temperatures, disease, drought, pests, or casualty. The provision is intended to permit all replanting costs, not just preproductive costs associated with restoring orchards or groves to their original condition to be deductible.
>
> * * *
>
> [I]n the case of vineyards destroyed by phylloxera B, preproductive costs, costs such as replacement vines, replanting of rootstocks, the purchase of trellis and drain tile and irrigation equipment solely to replace equipment, the removal of which was necessitated by the infestation, and the costs of land preparation, would all be deductible under this exception.
>
> * * *
>
> Of course, since it was the intention of this exception to place a taxpayer in the same position as before the loss occurred, we would assume the IRS would not permit a taxpayer to upgrade the vineyard, grove or orchard . . . Similarly, we should also assume the IRS will prevent a double deduction from occurring under section 165(m).

138 CONG. REC. S15593-15594 (daily ed. September 29, 1992) (statements of Sens. Packwood and Bentsen).

The Solution: Clarification through Amendment

Clarification of this provision would be possible through a simple rule stating that the exemption applies to all preproductive period costs and 80 percent of all other costs of a taxpayer incurred by replanting plants destroyed by freezing temperatures, disease, drought, pests, or casualty. The 80 percent figure provides a simple rule which is needed in recognition of the fact that not <u>all</u> expenditures related to replanting should be deductible. There are clearly some expenditures relating to the replanting of an agricultural product that benefit a business beyond that necessary to restore the agricultural output. Nevertheless, this rule also recognizes that a substantial portion of the replanting costs are properly deductible under the rule, as originally enacted by the Congress. The 80 percent rule would simplify administration of the tax law in this area. The amendment also retains full deductibility of preproductive expenses, which has never been contested by the IRS.

To avoid the double deduction to which Senator Packwood alluded in his colloquy, the proposed amendment would also redesignate subsection (m) of Section 165 as subsection (n) and insert new language which bars section 165 deductions where the costs of replanting are deducted under section 263A(d)(2)(A).

We believe that these proposed amendments would eliminate the confusion surrounding section 263A(d)(2), in a way which recognizes the original intent of Congress when the provision was enacted in 1986.

The Costs Inflicted by Phylloxera and Frostkill

Among other agricultural growers, vintners whose vineyards are infested with phylloxera or have suffered severe frost damage know as "frostkill" would be helped by this provision. Phylloxera is an aphid-like louse which cannot be combated by conventional pesticide methods; only the complete removal of the infested vineyards, including irrigation equipment, drain tiles, and trellis systems, followed by the fumigation and replanting of root stocks resistant to the pest, can remedy an infestation. Frostkill is a serious problem in the wine growing regions of New York, Pennsylvania, Ohio, Michigan, Missouri and Arkansas. Frostkill leads to seriously weakened vines that become extremely susceptible to disease and infestation. For example, as a result of recent severe weather in Missouri, Stone Hill Winery, the largest winery in the state, has been forced to remove an entire vineyard. There are numerous other examples of similar weather problems in other states. Whether the damage is caused by phylloxera, frostkill, or other grape related disease, the vines and roots cannot be removed without the elimination of related improvements, since the irrigation equipment, trellis systems, and drain tiles are completely intertwined with the vines.

By clarifying existing law, this amendment would greatly benefit not only the wine industry, which has been experiencing flat sales in recent years, but all grape growers in California, Oregon, and Washington; and, should the pestilence spread further, those grape growers in other parts of the United States could need this provision. In fact, the U.S. Department of Agriculture has warned that failure of grape growers to take effective action to protect themselves against the insects could lead to devastating consequences for vast areas of vineyards. If IRS' current interpretation is not modified, the ability of grape growers to respond to the threat posed by the phylloxera infestation will be seriously impaired, thus harming wine makers and grape growers alike. The proposed amendment would not provide an undue benefit to grape growers; instead, the provision would do no more than help ensure that these growers can regain the position in which they were prior to the casualty.

For example, Robert Mondavi expects to lose at least 80 percent or 813 acres of its vines to phylloxera infestation at an estimated cost of $21.2 million, which includes only replanting costs and not the three to four years of lost harvest returns. The costs of phylloxera will no doubt weigh heavily on Robert Mondavi, but the costs to the rest of the American wine industry may be more severe, causing less fortunate wine makers to fail. These dangers are facing the wine industry at a time when foreign competition is increasing.

Mr. Chairman, on behalf of the American Vintners Association, and the entire wine industry, I thank you and the entire Subcommittee for holding this hearing on the proposed amendment to clarify Internal Revenue Code section 263A(d)(2) and for the opportunity to express our opinions here today. I would be pleased to answer any questions you may have.

Mr. HOAGLAND. Do any members of the panel have—Mr. Jacobs.

Mr. JACOBS. I wanted to ask Mr. Houck, did the members of the committee understand correctly that your proposal actually contributes money to the U.S. Treasury? I don't mean fancifully that maybe it will induce something, but on the figures of the estimates of the Joint Committee?

Mr. HOUCK. That is true, Congressman. They have estimated that the repeal of the CIAC tax will cost the Treasury about $108 million, but the change in depreciation practices will pick up an additional $140 million over a 5-year period, so there is a net gain there of $32 million, excluding any benefits that come from allowing our businesses to continue to grow and become larger taxpaying entities.

Mr. JACOBS. That sounds like what that fellow said on January 20, 1961, ask not—how did that go?

Mr. HOUCK. Well, that is true in a way. We came up with this proposal ourselves. We feel so strongly about the way the CIAC tax inhibits our businesses and restricts their growth and, in fact, in some cases may be putting us out of business, that we were willing to go this route.

Mr. JACOBS. That looks like one of these wonderful win-win propositions.

Mr. HOUCK. I think it is.

Mr. JACOBS. I yield to Mr. Matsui.

Mr. MATSUI. I thank the gentleman from Indiana, and I thank him for the work that he has been putting in on this particular issue. Mr. Houck, the problem we have with current law is that we are using what amounts to a capital expense and requiring that it be treated as an ordinary expense. Because the PUCs require a flowthrough of the expenses, won't there be an increase in the cost of the average home? Furthermore, could you tell me what the estimate of those costs might be nationally?

Mr. HOUCK. Well, nationally I understand that it is about $2,000 a house, and in California I would suspect it is probably a little bit more than that because of the cost of development in California.

Mr. MATSUI. In terms of your overall assessment of this situation, is it correct that this has to be done because of the PUCs? Perhaps you can explain that for the record.

Mr. HOUCK. Well, you know, the tax has to be paid, there is no doubt about that.

Mr. MATSUI. In other words, it is a question of whether it is amortized or whether it is paid immediately, is that correct?

Mr. HOUCK. Well, that is true. We have to pay it immediately. The California commission came up with this sharing of the tax situation where the developer pays 33 percent, and then there is a tax on that tax, that is the gross up, and we end up adding about 20 percent of the original cost to the facility, so we get $100 facilities that cost $153, with $53 going to the Federal Government, and that drives up the cost of housing and the cost of water.

Mr. MATSUI. I have no further questions of Mr. Houck. I appreciate your involvement in this issue.

May I, Mr. Chairman, ask Mr. Schmidt a question?

Mr. HOAGLAND. Yes.

Mr. MATSUI. Mr. Schmidt, for clarification purposes, under current law, if you have to replant or if you have to put in new equipment, then those expenses are amortized. They are capital expenditures, are they not? Now, if replanting and replacement is due to a natural disaster, pesticides, pests that might destroy your crops or something of that nature, then under current law you can immediately expense those items; is that correct?

Mr. SCHMIDT. Well, that would be our interpretation, but the IRS is taking a much more limited——

Mr. MATSUI. The reason there is a problem with the Internal Revenue Service at this time is because the IRS says you can't improve your situation through the new investment beyond the original value; is that right?

Mr. SCHMIDT. Right.

Mr. MATSUI. The problem you face is the fact that with the improvements in technology in your industry and other industries, if you replace your equipment and recrop, you are going to get a higher yield.

Mr. SCHMIDT. That is a common perception, but what we are generally talking about is not so much new technology as new farming methods, and what we are really talking about is the spacing of the vineyards, and that is how close the vines are together, and the trellising system itself. The trellising system, compared to the old system which is constructed in a parallel fashion to the ground, is now more vertical. So, that is what they would be replacing. They would be doing this.

Mr. MATSUI. And you get a higher yield from your crops?

Mr. SCHMIDT. Not necessarily per acre. It is because the way the farming is done and the way we understand that the more grapes per vine that you produce, the less quality each little berry will have, so we limit——

Mr. MATSUI. But the Internal Revenue Service, however, is looking at crop yield, is that correct, and they are saying that you would be producing more and so therefore you can't expense it. They say you should amortize the cost, and thus will not allow you under the exception, or at least that is part of the rationale?

Mr. SCHMIDT. Right, and we disagree with that.

Mr. MATSUI. And it would seem to me—I understand you disagree with that—but it would seem to me that the correct interpretation, since you are not really changing the technology; is that correct?

Mr. SCHMIDT. Yes.

Mr. MATSUI. Is that it should fall within the current rules of allowing you to expense it if the replacement cost is due to a natural disaster or some act of God, is that your position?

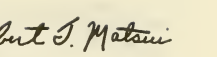
Mr. SCHMIDT. Yes. We believe that the existing law is there, but we are trying to clarify it.

Mr. MATSUI. In addition to that you are not avoiding any taxation because you would ultimately pay it. It would just be amortized; is that correct?

Mr. SCHMIDT. Absolutely.

Mr. MATSUI. I have no further questions. I thank both of the gentlemen.

[Mr. Matsui submitted the following statements:]



STATEMENT CONCERNING REPEAL OF THE TAX ON CONTRIBUTIONS IN AID OF CONSTRUCTION

THE HONORABLE ROBERT T. MATSUI
MEMBER OF CONGRESS
5TH DISTRICT, CALIFORNIA

Mr. Chairman, I am pleased to have this opportunity today to testify on H.R. 846, legislation to reinstate the exclusion from gross income of contributions in aid of construction (known as contributions or CIAC) to a water or wastewater utility. Passage of H.R. 846 will give a boost to the hard pressed housing industry, help protect water quality and result in additional tax revenues for the federal government. I have been the House sponsor of similar legislation since the tax treatment of contributed capital was changed in 1986 and hope to see it enacted this year.

When a utility extends service to a new customer, the capital - or its cash equivalent - is contributed by the customer to the utility. This is a CIAC. They are made in order to insulate existing customers from the cost and associated business risk of extending service to new customers.

Prior to enactment of the Tax Reform Act of 1986, CIAC were not included in the gross income of an investor-owned utility and therefore were not subject to federal income tax. In addition, utilities could not earn, take tax depreciation or investment tax credits on CIAC.

The '86 Act repealed section 118(b) of the Internal Revenue Code and thus subjected CIAC to tax as gross income. Removing the exclusion from gross income of CIAC was intended as a tax on utilities. In practice, the CIAC tax is <u>not</u> a tax on utilities, but a tax on utility customers, primarily developers and home buyers.

Public utility commissions (PUC), generally require utilities to pass tax costs onto their customers. This is done in one of two ways. The most common approach is to require the new customer to pay the cost of the tax, plus the tax on the tax known as a "gross-up". Depending on the state, a gross-up can add as much as 70 percent to the customer's cost of the contribution. Alternatively, the PUC may allow the utility to recover the tax cost from existing customers.

Whichever method is chosen, utilities do not pay the tax, they pass it on. But passing the tax on has detrimental effects, not only on the utility's ability to bring in new business, but on the environment and - most significantly - on the price of new housing and housing construction.

A developer will ultimately pass the cost of the CIAC and the gross-up on to the new home buyer. The National Association of Home Builders has estimated that the CIAC tax can increase the cost of new housing by as much as $2000 a unit. This additional cost is enough to end the dream of homeownership for a young couple.

Most important in my opinion, elimination of the CIAC tax will help get the real estate market back on its feet. Not by fueling real estate speculation, but by removing another barrier to the purchase of a new home. Anyone who has bought a house recently knows you just don't pay the price of the house. You pay closing costs, title costs, title insurance fees, attorneys' fees and points. And when you buy a house hooked up to privately owned utilities, you also pay the CIAC tax - as much as $2000 a unit.

The CIAC tax also has some important environmental effects. New customers can avoid paying the CIAC tax by building their own independent water systems. This leads to a proliferation of systems that may not have the financial, technical or managerial ability to comply with the rigorous requirements of the Safe Drinking Water Act. Such system are referred to as "non-viable". According to EPA, in fiscal year 1992, more than 90 percent of the violations of the Safe Drinking Water Act were made by systems serving less than 3,300 individuals. By encouraging the proliferation of non-viable systems, the CIAC tax frustrates the environmental policy goal of consolidating these systems into already existing, professionally managed systems.

To address these concerns, section 118(b) of the Internal Revenue Code, exempting contributions in aid of construction from gross income, should be restored. A tax on CIAC is a tax on capital, paid by a utility's new customers. We should tax income, not capital. Particularly in a case like this where the tax is affecting new home construction and the growth of the tax-paying water utility industry.

This legislation was most recently estimated to cost $108 million over five years. I have included a revenue offset in the bill as introduced that raises $140 million over the same period, thus netting $32 million for the federal government. The offset extends depreciation on new water utility plant from 20 to 25 years and switches from 150 percent declining balance to straight-line depreciation. In other words, in exchange for eliminating the upfront affect of the CIAC tax, the water industry is willing to pay more taxes over time.

This offset was suggested by the investor-owned water industry and is indivisible from the substance of the legislation which is the restoration of the exclusion of CIAC from gross income. The industry suggested it only for the purpose of repealing the CIAC tax, and that is its only intended use.

Mr. Chairman, repeal of the tax on CIAC for water and wastewater utilities will have a noticeable effect on both housing prices and environmental policy. It is supported by the National Association of Home Builders, the National Association of Water Companies and the National Association of Regulatory Utility Commissioners. Support for passage of this bill continues to grow. Since I introduced H.R. 846 on February 4, it has been cosponsored by 57 members, including 11 from this Committee. I urge the speedy adoption of this bill. It is non-controversial, more than revenue neutral and makes good tax policy.

Thank you for your consideration.

Robert T. Matsui

STATEMENT OF CONGRESSMAN ROBERT T. MATSUI
BEFORE THE
SUBCOMMITTEE ON SELECT REVENUE MEASURES
COMMITTEE ON WAYS AND MEANS

JUNE 17, 1993

Mr. Chairman, thank you for providing me with an opportunity to discuss and express my strong support for a proposal we are considering today. This proposal would clarify the application of the uniform capitalization rules to certain casualty agricultural crop losses. My interest in passage of this proposal is based primarily on my concern regarding the impact of the phylloxera infestation in my State. However, this proposal is not isolated to that type of casualty. The provision would clarify the tax treatment of expenses incurred by any grower of a crop for human consumption.

Section 263A(d)(2) of the Code provides an exception to the uniform capitalization requirements for losses of plants bearing edible crops. Section 263A(d)(2) states that the capitalization rules of section 263A "shall not apply to *any costs* of the taxpayer of replanting plants bearing the same type of crop . . ." that were lost or damaged "by reason of freezing temperatures, disease, drought, pests, or casualty" [emphasis added].

On its face, the language is clear and allows immediate expensing of ***all costs*** upon replanting. However, comments by the IRS indicate that section 263A is not all inclusive, and that only a portion of the costs of replanting, specifically pre-productive costs, may be deducted under section 263A(d)(2). I do not believe this interpretation reflects the action we took in 1986.

Although the legislative history governing section 263A(d)(2) does not explicitly address the interpretation of "any costs", that history strongly suggests that we passed the loss exemption so that it would apply more broadly to all costs associated with replanting. The Conference Report on the Tax Reform Act of 1986 ("1986 Act") highlights the fact that prior to the imposition of section 263A(d)(2), the Code had a former loss provision that permitted a taxpayer to deduct currently only "otherwise deductible replanting and maintenance costs" (former section 278(c)). The Conference Report further indicates that when we considered the loss provision in the 1986 Act, we changed the language of the former loss exemption (§ 278 (c)) to read that "replanting and maintenance costs incurred following loss of . . . [a] vineyard . . . are currently deductible even though replanting does not take place on the same property." We did not include the more limiting "otherwise deductible" language. The Senate Amendment broadened our language to permit taxpayers, other than the person who owns the vineyard, to deduct replanting and maintenance costs. Nothing in the Conference Report

explicitly mentioned or limited costs to those that were "otherwise deductible".

Moreover, the original House Report to the 1986 Act suggests that we intended to expand the former loss exemption of section 278(c). The House Report stated that "under the committee bill, the special rule of present law permitting expensing of amounts incurred in replanting after loss or damage due to freezing temperatures, disease, drought, pests, or casualty (sec 278(c)) is expanded with respect to edible crops to include expenditures in connection with planting or maintaining a field other than the field in which the damage occurred." While the House Report does not explicitly discuss which costs can be deducted, the fact that we modified and expanded the old loss exemption implies a broader interpretation of section 263A(d)(2) was intended.

The fact that we may have intended a broader interpretation of the types of costs that could be deducted is further evidenced by the decision not to incorporate the Senate Amendment which maintained the former loss exemption and did not modify the *otherwise deductible* language in this code provision.

The pre-1986 language was certainly easier to understand. The report language accompanying the former loss exemption (§ 278(c)) had explicitly stated that section 278(a), requiring capitalization of pre-productive expenses, would not apply to amounts allowable as deductions for vineyard replanting caused by reason of disease or pests. Unfortunately no such clarity applies to the 1986 Act loss provision which changed the language to the more inclusive *all costs* terminology and which does not explicitly impose pre-productive cost limits.

While it appears congressional intent supports a broader interpretation of the deductibility of replanting costs under section 263A(d)(2) beyond merely pre-productive costs, it is impossible to decipher precisely at this time.

Mr. Chairman, as you know, farming is an unusual business in the United States. The entities engaged in farming are usually smaller than industrial manufacturing entities and are often deficient in their ability to finance capital expenditures. Congress has recognized this problem when drafting provisions in the tax code affecting farming businesses.

Similar recognition through clarifying language is needed now. With phylloxera damage, each grower who is forced to replant a vineyard is faced with a major and unexpected drain on capital resources. The effect of capitalizing most of the costs of replanting is to require that a vineyard owner obtain additional cash which may be impossible to obtain. If the Code is clarified to allow full expensing, cash requirements may be partially offset against current taxes. Such a treatment would reduce the hemorrhaging of these impacted farms.

I thank you again, Mr. Chairman, for holding these hearings and for giving me this opportunity to comment on this legislation.

Mr. HOAGLAND. As I understand it, Mr. Schmidt, your proposal would allow expensing not only of costs required to restore crops, but also permanent improvements, for instance, the installation of a new irrigation system if that were occasioned by a national disaster?

Mr. SCHMIDT. Yes. In our particular type of grape growing, the irrigation systems are so intertwined with the trellising systems and the vines, because it is drip irrigation and generally isn't overhead sprinklers, and as the vines grow up, they grow around these sprinklers, so you have to tear the whole thing out. There is no saving them.

Mr. HOAGLAND. Now, would that treatment have the effect of putting a farmer who suffered a disaster in a better position than one that hasn't?

Mr. SCHMIDT. No, it would put the one who suffered a disaster back in the same position because he can't save the irrigation system.

Mr. HOAGLAND. But you are able to expense the irrigation system, though, right?

Mr. SCHMIDT. Yes.

Mr. HOAGLAND. Rather than view it as a capital investment?

Mr. SCHMIDT. Yes, we would be allowed to expense the replacement costs for some capital assets. However, the new asset would retain the basis of the old—but now destroyed—asset on our books and would retain its character as a capital asset for tax purposes. Accordingly, because all we are doing is replacing an existing asset, for which we are now incurring costs for the second time, we receive no new benefit. The legislation further ensures we receive no additional benefit because we would not be able to take a section 165 loss deduction.

Mr. HOAGLAND. OK. Thank you. Mr. Jacobs.

Mr. JACOBS. I just can't help noting that we have a man representing the water industry and a man representing the wine industry. Would you care to put your heads together and tell us which one is better for you? I think your answer is at different times different ones. All right.

Mr. HOAGLAND. Any other observations or questions? Thank you, gentlemen.

OK. Now we will invite panel 3 to step forward, please. First we have Donna Walker who is here with PPG Industries. Mr. Coyne, as I understand it, will introduce Donna Walker, Randy Dyer with National Structured Settlement Trade Association, Robert Crispin with Travelers, Larkin Teasley with Golden State, and Virginia Shehee with Louisiana Insurers' Conference, and Mr. McCrery is to introduce Virginia Shehee; is that right? So why don't we begin with Mr. Coyne introducing Donna Walker, and then after Donna Walker's testimony, why, Mr. McCrery may introduce Virginia Shehee, and after her testimony we will go to Mr. Dyer, then Mr. Crispin, then Mr. Teasley.

Mr. COYNE. Thank you, Mr. Chairman. It does give me great pleasure to welcome Donna Walker here today as a representative of Pittsburgh Plate Glass, an outstanding corporate citizen of the city of Pittsburgh and my 14th Congressional District, and, of

course, an outstanding producer of glass and paint products for the whole world. I look forward to hearing your testimony.

STATEMENT OF DONNA LEE WALKER, DIRECTOR OF TAX ADMINISTRATION, PPG INDUSTRIES, INC., PITTSBURGH, PA.

Ms. WALKER. Thank you, Congressman Coyne. Mr. Chairman, members of the subcommittee, I appreciate this opportunity to testify today, and I would like to begin by saying that although PPG disagrees with the position taken in Revenue Ruling 90–65, which disallows depreciation of an asset involved in manufacturing which is made from platinum and other costly materials, my purpose here today is to protest the use of section 481 to make an alleged prospective ruling, in fact, a retroactive ruling.

Revenue Ruling 90–65 holds that an economically recoverable precious metal fabricated into items used in a taxpayer's trade or business is not depreciable if the cost of the recoverable metal is more than half the total cost of the fabricated item. Revenue Ruling 90–65 revoked Revenue Ruling 69–55 which held that these costs were subject to depreciation.

PPG uses significant quantities of platinum and platinum/rhodium alloys in its flat glass and fiberglass manufacturing operations. PPG's tax treatment of these metals was the subject of numerous discussions with the Service and the Justice Department over an extended period of years. PPG spent a considerable amount of time and money pursuing its claims which eventually resulted in a concession by the Justice Department of PPG's ability to depreciate assets made from platinum for years commencing with 1971 based on the Commissioner's position as set forth in Revenue Ruling 69–55.

As part of a compromise settlement, concessions were made by PPG not only on the method of depreciation of platinum parts, but also other issues. Revenue Ruling 90–65 revokes Revenue Ruling 69–55 and concludes, in effect, that the glass industry may not depreciate platinum. Revenue Ruling 90–65 purports to be prospective in its application. The prospective application of Revenue Ruling 90–65 is illusory, however, with respect to depreciation. The ruling holds that in order to conform with the holding of the ruling with respect to depreciation, a taxpayer must change its method of accounting for all platinum on hand and make the necessary adjustments under section 481(a). It is the adjustments under section 481 of the code which result in significant adverse tax consequences and to which PPG objects. Not only is PPG denied depreciation on platinum acquired in 1991 and later years, but PPG must also take into income currently all of the depreciation allowed on platinum parts in prior years. By characterizing the revocation of Revenue Ruling 69–55 as a change in the taxpayer's method of accounting, the Service requires the immediate recapture of much of PPG's depreciation deductions for earlier years, including years covered by the prior settlement. PPG does not object to the Service's right to change its position, but we strenuously object to the essentially retroactive holding of Revenue Ruling 90–65 on the very fundamental basis of fairness in the administration of the tax laws. Thank you for your time.

[The prepared statement follows:]

STATEMENT OF DONNA LEE WALKER,
DIRECTOR OF TAX ADMINISTRATION, PPG INDUSTRIES, INC.,
PITTSBURGH, PA.

Mr. Chairman, members of the Subcommittee, my name is Donna Walker. I am Director of Tax Administration for PPG Industries, Inc. PPG is headquartered in Pittsburgh, Pennsylvania and is a worldwide manufacturer of glass, fiber glass, chemicals, coatings and resins. The Company employs some 20,000 people in the United States and another 12,000 around the world; has been in business since the late 1800's; and had 1992 annual sales approaching $6.0 billion.

I appreciate this opportunity to testify on the tax accounting issue relating to Internal Revenue Code section 481, and its impact on taxpayers under Revenue Ruling 90-65.

I would like to begin by saying that although PPG disagrees with the position taken in Rev. Rul. 90-65 disallowing depreciation of an asset involved in manufacturing which is made from platinum and other costly materials, my purpose today is to protest the use of section 481 to make an alleged prospective ruling, in fact a retroactive ruling.

On August 13, 1990 the Internal Revenue Service (the "Service") issued Revenue Ruling 90-65, 1990-2 C.B.41. This revenue ruling has potentially significant adverse tax consequences to PPG and others in glass manufacturing industries. In PPG's case, as well as most other glass manufacturers, the practical effect of this ruling will be to reverse previously settled litigation on this issue and to increase taxable income.

Rev. Rul. 90-65 holds that an economically recoverable precious metal fabricated into items used in a taxpayer's trade or business is not depreciable if the cost of the recoverable metal is more than half the total cost of the fabricated item. Rev. Rul. 90-65, the 1990 ruling, revoked Rev. Rul. 69-55, 1969-1 C.B. 26, which held that the costs of an economically recoverable metal (platinum), which was fabricated into manufacturing parts and equipment with useful lives of over one year, were subject to depreciation. The 1990 ruling requires that deductions for the cost of such platinum and other precious metals are limited to actual losses, subject to further capitalization requirements if inventory is produced.

PPG uses significant quantities of platinum and platinum/rhodium alloys in its flat glass and fiber glass manufacturing operations. PPG's tax treatment of these metals was the subject of numerous discussions with the Service and the Justice Department over an extended period of years. PPG spent a considerable amount of time and money pursuing its claims, which eventually resulted in a concession by the Justice Department of PPG's ability to depreciate assets made from platinum for years commencing with 1971 based upon the Commissioner's position as set forth in Rev. Rul. 69-55. As part of a compromise settlement, concessions were made by PPG not only on the method of depreciation of platinum parts, but also on other issues.

The settlement of PPG's claims for refund for 1971 through 1973 and the carry through of that settlement for subsequent years was founded upon Rev. Rul. 69-55 (the "platinum ruling"). In the platinum ruling, the Service held that although platinum was not depreciable, platinum parts used in a glass manufacturing operation could become depreciable property if such parts had an estimated life in excess of one year. Based on the platinum ruling, the Government settled PPG's claims by permitting PPG to depreciate fabricated platinum parts having a useful life in excess of one year.

Rev. Rul. 90-65 revokes Rev. Rul. 69-55 and concludes, in effect, that the glass industry may not depreciate platinum. Rev. Rul. 90-65 purports to be prospective in its application, that is, to apply

only in 1991 and later years. The prospective application of Rev. Rul. 90-65 is illusory, however, with respect to depreciation. The ruling holds that in order to conform with the holding of the ruling with respect to depreciation, a taxpayer must change its method of accounting for all platinum on hand and make the necessary adjustments under section 481(a).

It is the adjustments under section 481 of the Code which result in significant adverse tax consequences and to which PPG objects. Not only is PPG denied depreciation on platinum acquired in 1991 and later years, but PPG must also take into income currently all of the depreciation allowed on platinum parts in prior years. By characterizing the revocation of the platinum ruling as a change in the taxpayer's method of accounting, the Service requires the immediate recapture of much of PPG's depreciation deductions for earlier years, including years covered by the prior settlement.

The implications of Rev. Rul. 90-65 to PPG and other glass manufacturers who have depreciation deductions under Rev. Rul. 69-55 are substantial. The adjustment under section 481(a) will be the difference between the depreciation deductions claimed for all years prior to 1991 and the amount which would have been claimed had actual losses been deducted. In PPG's case, this difference amounts to tens of millions of dollars, which will be required to be taken into income now. Rev. Rul. 90-65 therefore recaptures into income over a very short period of time all depreciation deductions in excess of actual losses sustained by glass manufacturers for all years prior to 1991, even though these deductions were agreed to by the government in the settlement of PPG's litigation claims.

PPG does not object to the Service's right to change its position as reflected in Rev. Rul. 90-65. But we strenuously object to the essentially retroactive holding of Rev. Rul. 90-65 on the very fundamental basis of fairness in the administration of the tax laws. PPG, as well as all other taxpayers similarly situated, hammered out settlements (with mutual concessions) at considerable expense supporting the theory of the Service's flagship ruling, Rev. Rul. 69-55. Indeed, in all of PPG's negotiations with the Justice Department and the Service on this matter, the single most fundamental requirement of any proposed settlement was that it comport with the theory of Rev. Rul. 69-55 that platinum is not depreciable, but platinum parts with a life in excess of one year are.

Rev. Rul. 69-55 states that "(w)hen the fabricated items containing platinum are placed in service, those items having a useful life of over one year take on characteristics of depreciable property. . . The fabricated platinum items having a useful life of over one year are in the only form that the platinum metal could give rise to a depreciation deduction by the taxpayer in the instant case." PPG relied upon this statement to depreciate items fabricated from platinum with a useful life exceeding one year. Such reliance is explicitly sanctioned by the Internal Revenue Service. See Rev. Proc. 89-14, 1989-1 C.B. 814, 815, stating that "(r)evenue rulings . . . are published to provide precedents . . . and may be cited and relied upon for that purpose." In addition, Rev. Rul. 90-65 explicitly states that it intends to provide relief for taxpayers relying on Rev. Rul. 69-55. The requirement of adjustments under section 481, however, negates any relief because PPG, which relied in good faith on Rev. Rul. 69-55, would be required to include all previous depreciation deductions relating to platinum in income, to the extent the platinum still existed, over a relatively short period of time. Thus, PPG, which relied on a published Revenue Ruling, is unduly burdened.

Now, after having negotiated settlements which adopt Rev. Rul. 69-55, the Service has withdrawn and repudiated the theory of that ruling to the direct detriment of the taxpayers who have been following that ruling in good faith.

PPG does, however, support the proposal that allows for true prospective application of Rev. Rul. 90-65 in the case of fabricated platinum parts used in manufacturing.

Thank you.

Mr. HOAGLAND. Thank you.

Mr. McCrery.

Mr. MCCRERY. Thank you, Mr. Chairman. It is a pleasure for me to introduce to the members of our subcommittee today Virginia Shehee, who is from my hometown of Shreveport, La. Mrs. Shehee serves as president and chief executive officer of Kilpatrick Life Insurance Co., which is domiciled in Shreveport. She also has served as an officer in the Louisiana Insurers Conference, which is an association of small life insurance companies domiciled in the State of Louisiana.

In addition to her extensive business experience and community service, Mrs. Shehee was also a member of the Louisiana State Senate for a number of years and so she brings to us a unique perspective of one who has not only been in the business world, but has served the public. Mrs. Shehee will talk to us today about a problem in the Tax Code that appears to me to be unfairly and unduly harsh in its application to small life insurance companies.

I think Mr. Teasley will also talk about the same problem. I know the chairman of the subcommittee, Mr. Rangel, has an interest in this matter as well, so I commend to the members of the panel Mrs. Shehee's testimony.

Mr. HOAGLAND. Mrs. Shehee, you are recognized for 3 minutes.

STATEMENT OF VIRGINIA KILPATRICK SHEHEE, PRESIDENT AND CHIEF EXECUTIVE OFFICER, KILPATRICK LIFE INSURANCE CO.; AND PRESIDENT, CENTRAL STATE LIFE INSURANCE CO., ALEXANDRIA, LA., SHREVEPORT, LA., ON BEHALF OF LOUISIANA INSURERS' CONFERENCE

Ms. SHEHEE. Mr. Chairman, members of the committee, you already know who I am. I am Virginia Kilpatrick Shehee, president of Kilpatrick Life, domiciled in Shreveport, La., and president of Central State Life Insurance Co., domiciled in Alexandria, La. I appear here today to discuss the removal of the small life insurance company deduction from the alternative minimum tax calculation, and from the requirement of the code section 848 to capitalize insurance policy acquisition expenses.

First, in computing a life insurance company's taxable income, a small life insurance company, one with assets under $500 million, is allowed a special deduction equal to 60 percent of its first $3 million in income. The small life insurance company deduction is intended to help the smaller companies grow and thereby provide security for their policyholders. It recognizes the fact that the smaller companies do not have the benefit of economies of scale, but nevertheless they provide an important service to the U.S. economy. However, this deduction is not allowed in determining the adjusted current earnings, ACE, for purposes of computing the alternative minimum tax, the disallowance of this deduction in calculation alternative minimum tax represents a 25 percent increase in the effective tax rate of a small life insurance company, shown in our appendix 8.

This disallowance virtually neutralizes the intended benefits of the small life insurance company deduction. Second, policy acquisition costs represent the expenses associated with issuing insurance policies. Such costs include underwriting costs and agents' commis-

sions. As a matter of practice, life insurance companies face heavy policy acquisition costs. These are real dollar costs payable at the time the policy is issued, and not deferred costs payable over the life of the policy.

As such, these costs result in a direct reduction to our surplus. Although such growing costs are often viewed as investing for the future, the future for companies with limited surplus becomes more and more questionable with the requirement under the code section 848 to capitalize and amortize 7.7 percent of annual net premiums as deferred acquisition costs. The fact that the 7.7 percent is applied to both first year and renewal premiums is particularly damaging to life insurance companies since our premiums are designed to remain the same for the life of the policy; that is, we do not adjust our premium rates every 6 or 12 months. The premium rates on the existing business were tested and approved based upon the tax picture at that time.

The application of the DAC tax to the renewal premiums especially hurts small life insurance companies trying to increase surplus while staying competitive in the marketplace.

We understand that in theory these capitalized costs represent deductible costs at some point in the future. However in practice this only occurs when there is a reduction in the company's total premium income. For small companies subject to the AMT the DAC tax represents a cost of 17 percent of the net amount of capitalization. This may prove to be a final blow for small companies attempting to grow by limiting the amount of surplus available to fund this growth.

With their inability to increase premiums on existing policies, with the new NAIC regulations, and the additional tax burdens created by both the DAC tax and the disallowance of the small life insurance company deduction, in calculating the AMT, small companies are faced with the concern of how to stop the drain on surplus.

I propose that the small life insurance companies be defined as those companies with less than $500 million in assets. These companies should be allowed the full small life insurance company deduction when calculating adjusted current earnings for alternative minimum tax.

I also propose that small life insurance companies be exempt from the requirements under code section 848 to capitalize and amortize 7.7 percent of annual net premiums as deferred acquisition costs.

There are today approximately 1,300 small life insurance companies in the United States—and there are 90 in Louisiana—who service the smaller urban and rural areas of lower- to middle-class America. We provide thousands of jobs and job stability with our recession-proof industry. We own property used for offices, pay premium and property taxes and provide leaders for our communities. We stimulate growth in these communities through the direct financing of local residential and commercial mortgage loans. There are times when we are the only source of long-term financing for these projects.

We, as a group, are also heavily invested in our country through the purchase of various Government bonds, such as GNMAs, U.S. Treasuries, and other State and municipal bonds.

The ultimate service we provide is financial security when the breadwinner of a household dies unexpectedly. This service cannot and should not be minimized.

In the long run, the benefits of the receipt of both of these exemptions will outweigh the short-term loss of tax revenue. Small life insurance companies provide home office services and investments in communities where it is not cost beneficial for the larger companies to operate.

Thank you, Mr. Chairman, for your consideration regarding the critical concerns to the well-being of small life insurance companies. Thank you.

Mr. HOAGLAND. Thank you, Ms. Shehee, for your testimony. We have someone in Omaha, and I have heard the same testimony.

Ms. SHEHEE. Have you, sir?

Mr. HOAGLAND. Yes.

[The prepared statement and attachments follow:]

INSURANCE, ITEMS #1 & #6
RESPONSE

Mr. Chairman and members of the committee:
My name is Virginia Kilpatrick Shehee, President and Chief Executive Officer of Kilpatrick Life Insurance Company domiciled in Shreveport, Louisiana and Central State Life Insurance Company domiciled in Alexandria, Louisiana. I appear here today to discuss the removal of the small life insurance company deduction from the alternative minimum tax calculation AND from the requirement under Code Section 848 to capitalize insurance policy acquisition expenses.

First, in computing a life insurance company's taxable income, a small life insurance company (one with assets under $500 million) is allowed a special deduction equal to 60% of its first $3 million in income. The small life insurance company deduction is intended to help the smaller companies grow and thereby provide security for their policyholders. It recognizes the fact that the smaller companies do not have the benefit of economies of scale, but nevertheless, they provide an important service to the United States economy. However, this deduction is not allowed in determining the adjusted current earnings (ACE) for purposes of computing the alternative minimum tax. The disallowance of this deduction in calculating alternative minimum tax represents a 25% increase in the effective tax rate of a small life insurance company as shown in Appendix A. This disallowance virtually neutralizes the intended benefits of the small life insurance company deduction.

Secondly, policy acquisition costs represent the expenses associated with issuing insurance policies. Such costs include underwriting costs and agents commissions. As a matter of practice, life insurance companies face heavy policy acquisition costs. These are real dollar costs payable at the time the policy is issued, and not deferred costs payable over the life of the policy. As such, these costs result in a direct reduction in surplus.

Although such growing costs are often viewed as investing for the future, the future for companies with limited surplus becomes more and more questionable with the requirement under Code Section 848 to capitalize and amortize 7.7% of annual net premiums as deferred acquisition costs (DAC). The fact that the 7.7% is applied to both first year and renewal premiums is particularly damaging to life insurance companies since our premiums are designed to remain the same for the life of the policy, i.e., we can not adjust our premium rates every six or twelve months. The premium rates on existing business were tested and approved based upon the tax structure at that time. The application of the DAC tax to the renewal premiums especially hurts small life insurance companies trying to increase surplus while staying competitive in the marketplace.

We understand that in theory these capitalized costs represent deductible costs at some point in the future. However, in practice this only occurs when there is a reduction in the company's total premium income. For small companies subject to the alternative minimum tax (AMT), the DAC tax represents a cost of 17% (See Appendix B) of the net amount capitalized. This may prove to be the final blow for small companies attempting to grow by limiting the amount of surplus available to fund this growth.

With its inability to increase premiums on existing policies, with new NAIC regulations (Appendix C), and the additional tax burdens created by both the DAC tax and the disallowance of the small life insurance company in calculating the AMT, small companies are faced with the concern of how to stop the drain on surplus.

I propose that small life insurance companies be defined as those companies with less than $500 million in assets. These companies should be allowed the full small life insurance company deduction when calculating adjusted current earnings for alternative minimum tax. I also purpose that small life insurance companies be exempt from the requirements under Code Section 848 to capitalize and amortize 7.7% of annual net premium as deferred acquisition costs.

There are today approximately 1300 small life insurance companies in the United States (90 in Louisiana) who service the smaller urban and rural areas of lower to middle-class America. We provide thousands of jobs and job stability with our recession-proof industry. We own property used for offices, pay premium and property taxes and provide leaders for our communities. We stimulate growth in these communities through the direct financing of local residential and commercial mortgage loans. There are times when we are the only source of long-term financing for these projects. We, as a group, are also heavily invested in our country through the purchase of government bonds, i.e., GNMA's, U.S. Treasury bonds and other state and municipal bonds. The ultimate service we provide is financial security when the breadwinner of a household dies unexpectedly. This service can not, and should not, be minimized.

In the long run, the benefits of the receipt of both of these exemptions will outweigh the short-term loss of tax revenue. Small life insurance companies provide home office services and investments in communities where it is not cost beneficial for the larger companies to operate. Thank you for your consideration of these critical concerns to the well-being of small life insurance companies.

Small Life Insurance Company Deduction
As Neutralized by AMT

APPENDIX A

In the alternative minimum tax calculation 75% of the 60% small life deduction is added back to taxable income. This amount is then taxed at 20%. This raises the effective tax rate to 17% from 13.6%, which is a 25% tax increase. Below is an example based on $100 of income showing how these percentages were attained.

	Regular Tax	Alternative Minimum Tax	Increase
Gain from Operations	$100.00	$100.00	
Small Life Deductions (60%)	(60.00)	(60.00)	
Life Insurance Taxable Income	$ 40.00	$ 40.00	
Adjusted Current Earnings Adjustment 75% of Small Life Deduction		45.00	
Alternative Minimum Taxable Income		$ 85.00	
Tax Rate	34%	20%	
Federal Income Tax	$ 13.60	$ 17.00	$ 3.40
Percent Increase			25%

APPENDIX B

Deferred Acquisition Cost Tax Consequences

The deferred acquisition cost requirement requires the addition to taxable income of 7.7% of life insurance premiums. Below is an example, assuming $500 of premium income, that demonstrates the effect of this tax. The cost to a small life insurance company that is subject to the alternative minimum tax is equal to 17% of the amount capitalized less current year amortization.

	AMT Tax	Effect of DAC on AMT Tax	Increase
Gain from Operations	$100.00	$100.00	
7.7% of Premium Income (DAC)		38.50	
Small Life Deduction (60%)	(60.00)	(83.10)	
Life Insurance Taxable Income	$ 40.00	$ 55.40	
Adjusted Current Earnings Adjustment 75% of Small Life Deduction	45.00	62.33	
Alternative Minimum Taxable Income	$ 85.00	$117.73	
Tax Rate	20%	20%	
Federal Income Tax	$ 17.00	$ 23.55	$ 6.55
Percent of Deferred Acquisition Cost ($6.55/$38.50)			17%

APPENDIX C

Recent NAIC Requirements
Addendum

Asset Valuation Reserve (AVR) applies to the specific risk characteristics of all invested asset categories excluding cash, policy loans, premium notes, collateral loans and income receivables. The AVR breaks down into two major components, each containing two subcomponents as follows:

Default Component	Equity Component
(1) Bonds and Preferred Stock	(1) Common Stock
(2) Mortgage Loans	(2) Real Estate and/other Invested Assets

All asset types have minimum and maximum reserve factors as shown below:

Bonds	0 to 20%
Preferred Stocks	3 to 22%
Short-Term Investments	0 to 20%
Mortgage Loans	1.75 to 10.5%
Common Stock	20 to 33.3%
Real Estate	7.5%

The appropriate reserve factors are multiplied by the account balance of each individual asset category to determine the amount of the reserve paid. That amount is then deducted from the surplus earnings of the company and set up as a liability on the financial statements.

This AVR replaced the Mandatory Securities Valuation Reserve (MSVR) in 1992. The MSVR only established reserves on bonds, preferred stocks and common stocks while the AVR is much broader and covers all of the assets listed above.

Asset Adequacy Analysis
The NAIC Model Actuarial Opinion and Memorandum Regulation requires that companies not meeting certain capital and surplus requirements are subject to an asset adequacy analysis to be performed by an appointed actuary. The capital and surplus requirements are as follows:

(1) Companies whose assets do not exceed $20 million - the sum of capital and surplus is at least 10% of the sum of cash and invested assets.
(2) Companies whose assets exceed $20 million but do not exceed $100 million - the sum of capital and surplus is at least 7% of the sum of cash and invested assets.
(3) Companies whose assets exceed $100 million but do not exceed $500 million - the sum of capital and surplus is at least 5% of the sum of cash and invested assets.
(4) Companies whose assets exceed $500 are required to submit a statement of actuarial opinion.

Risk Based Capital (RBC):
Risk Based Capital (RBC) is a means of measuring the amount of capital needed by an insurance company to support its business operations based upon its size and risk profile. The four risks involved in the risk profile are:

(1) Asset risk - risk of asset default.
(2) Insurance risk - risk of adverse mortality and morbidity experience.
(3) Interest Rate risk - risk of policyholders withdrawing funds due to higher interest rates in alternative investments.
(4) Business risk - normal business and management risk

Louisiana Insurers' Conference
Regular Member Companies

Company/Contact	NAIC Code	1991 Total Assets
Bankers Life of LA Ins. Co. William Chastain Wardlaw, President P. O. Box 2010 Ruston, LA 71273 Phone: (318) 255-7272	61298	4,523,121
Central American Life Ins. Co. Tex R. Kilpatrick, President P. O. Box 217 West Monroe, LA 71294 Phone: (318) 329-8181	76716	25,901,434
Central State Life Ins. Co. Virginia K. Shehee, President & CEO P. O. Drawer 151 Alexandria, LA 71301 Phone: (318) 443-3666	61743	28,895,583
Dixie Life Ins. Co. Charles J.D. Gerrets, III, President P. O. Box 69 Bogalusa, LA 70427 Phone: (504) 735-1710	73733	11,031,887
Evangeline Life Ins. Co. Charles J.D. Gerrets, III, President P. O. Box 13098 New Iberia, LA 70562 Phone: (318) 364-1721	73946	8,621,255
Family Financial Life Ins. Co. Jack Panno, Secretary P. O. Box 19685 New Orleans, LA 70179 Phone: (504) 456-0101	N/A	N/A
First Capital Life Ins. Co. of LA Frederick (Fritz) Eagan, President P. O. Box 50939 New Orleans, LA 70130 Phone: (504) 561-7700	74985	67,011,010

Louisiana Insurers' Conference
Regular Member Companies

Company/Contact	NAIC Code	1991 Total Assets
General Financial Life Ins. Co. Jack Panno, Secretary P. O. Box 19685 New Orleans, LA 70179 Phone: (504) 456-0101	N/A	N/A
Gertrude Geddes Willis Joseph Misshore, Jr., President & CEO P. O. Box 53272 New Orleans, LA 70153 Phone: (504) 522-2525	N/A	N/A
Guaranty Income Life Ins. Co. Thomas "Tom" Clark, President P. O. Box 2231 Baton Rouge, LA 70821 Phone: (504) 383-0355	64238	139,151,038
Kilpatrick Life Ins. Co. Virgiana K. Shehee, President & CEO P. O. Box 88 Shreveport, LA 71161 Phone: (318) 222-0555	74918	34,551,267
Lafourche Life Ins. Co. Charles J.D. Gerrets, III, President P. O. Box 246 Raceland, LA 70394 Phone: (504) 537-7537	74942	13,567,172
Life Ins. Co. of LA George D. Nelson, President P. O. Box 1803 Shreveport, LA 71166 Phone: (318) 221-0646	75094	6,323,409
Magnolia Life Ins. Co. Harvey Keiffer, President P. O. Drawer 3229 Lake Charles, LA 70602 Phone: (318) 433-1405	65803	83,345,314

Louisiana Insurers' Conference
Regular Member Companies

Company/Contact	NAIC Code	1991 Total Assets
Melancon Life Ins. Co. Gerald W. Melancon, President P. O. Box 100 Carencro, LA 70520 Phone: (318)235-3315	N/A	N/A
Metropolitan Life Ins. Co. Harry Kamen, President One Madison Avenue New York, NY 10010 Phone: (212) 578-2163	N/A	N/A
Mothe Life Ins. Co. Charles J.D. Gerrets, III, President P. O. Box 2128 Gretna, LA 70054 Phone: (504) 362-7222	66303	22,975,085
Mulhearn Protective Insurance Co., Inc. Peter G. Mulhearn, President P. O. Box 1411 Monroe, LA 71210 Phone: (318) 329-0141	75485	4,240,574
Old South Life Ins. Co. W.D. Bill Holder, President P. O. Box 845 Winnfield, LA 71483 Phone: (318) 628-6921	75965	4,361,231
Pan-American Life Ins. Co. John K. Roberts, President & CEO P. O. Box 60219 New Orleans, LA 70160 Phone: (504) 566-3776	67539	2,056,034,334
Pellerin Life Ins. Co. Frank E. Pellerin, President 118 Berard Street Breaux Bridge, LA 70517 Phone: (318) 332-2111	76317	4,194,745

Louisiana Insurers' Conference
Regular Member Companies

Company/Contact	NAIC Code	1991 Total Assets
Rabenhorst Life Ins. Co. A.P. Rabenhorst, President P. O. Box 2666 Baton Rouge, LA 70821 Phone: (504) 387-0171	76767	22,885,791
Reliable Life Ins. Co. Joseph H. Miller, President & CEO P. O. Box 1157 Monroe, LA 71210 Phone: (318) 387-1000	76805	4,175,710
Sabine Life Insurance Eloise Meadows, President P. O. Box 119 Many, LA 71449 Phone: (318) 256-2812	76937	1,937,581
Schoen Life Ins. Co. Charles J.D. Gerrets, III, President P. O. Box 19263 New Orleans, LA 70179 Phone: (504) 486-7212	71293	13,051,829
State National Life Ins. Co. Jack H. Cutrer, President & CEO P. O. Box 3557 Baton Rouge, LA 70821 Phone: (504) 379-4010	71102	56,209,265
Union National Life Ins. Co. Robert S. Greer, Jr., President P. O. Box 3638 Baton Rouge, LA 70821 Phone: (504) 927-3430	69773	226,886,604
United Companies Life Ins. Co. Gary L. Warrington, President P. O. Box 1591 Baton Rouge, LA 70821 Phone: (504) 924-6007	69876	1,208,878,016

Louisiana Insurers' Conference
Regular Member Companies

Company/Contact	NAIC Code	1991 Total Assets
Washington Life Ins. Co. of America D. Roy Domingue, President & CEO P. O. Box 3468 Lafayatte, LA 70502 Phone: (318) 233-0230	70300	37,388,943
Western Fidelity Ins. Co. Ericson Berg, President & CEO P. O. Box 901010 Fort Worth, TX 76101 Phone: (817) 451-7200	77879	23,372,896
Wilbert Life Ins. Co. John W. Wilbert, Jr. President P. O. Box 699 Plaquemine, LA 70764 Phone: (504) 687-1850	N/A	N/A

June 15, 1993
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LOUISIANA DOMESTIC COMPANIES

COMPANY NAME	# EMPLOYEES
Bankers Life of Louisiana	6
Central American Life Insurance	106
Central State Life Insurance Company	81
Dixie Life Insurance Company	21
Evangeline Life Insurance Company	24
Family Financial Life Insurance Company	18
First Capital Life Insurance Company of LA	18
General Financial Life Insurance Company	18
Gertrude Geddes Willis	N/A
Guaranty Income Life Insurance Company	32
Kilpatrick Life Insurance Company	151
Lafourche Life Insurance Company	24
Magnolia Life Insurance Company	205
Melancon Life Insurance Company	7
Metropolitan LIfe Insurance Company	268
Mothe Life Insurance Company	38
Mulhearn Protective Insurance Company	15
Old South Life Insurance Company	21
Pan American Life Insurance Company	635
Pellerin Life Insurance Company	14
Rabenhorst Life Insurance Company	30
Reliable Life Insurance Company	32
Sabine Life Insurance	3
Schoen Life Insurance Company	27
Security Industrial Insurance Company	755
State National Life Insurance Company	248
State Mutual Life Insurance Company	250
Union National Life Insurance Company	819
United Companies Life Insurance Company	96
Washington Life Insurance Company of America	25
Western Fidelity Insurance Company	175
Wilbert Life Insurance Company	9
TOTAL	4171

Other Domiciled Life Companies for Louisiana

Company	NAIC Code	1991 Total Assets
Acadian Life Ins. Co.	94153	322,136
American Liberty Life Ins. Co.	90298	11,240,360
Bluebonnet Life Ins. Co.	68535	4,412,241
Colonial American Life Ins. Co.	73326	2,743,845
Delta National Life Ins. Co.	68659	1,095,247
Eagle American Life Ins. Co.	94137	334,835
Escude Life Ins. Co.	91332	1,444,334
Estate Assurance Co.	68730	25,405,401
Federal Life Assurance Guar. Co.	75876	634,659
First Assurance Life of America	94579	7,974,994
First Financial Life Ins. Co.	97187	3,139,000
Gulfco Life Ins. Co.	74640	5,734,517
International Reinsurance Co.	80349	35,903,532
Investors Diversified Ins. Corp.	91480	531,015
Liberty Heritage Life Ins. Co.	94110	1,700,487
LA National Life Ins. Co.	75132	43,725,169
LA Security Ins. Co.	69248	3,285,187
Maison Blanche Life Ins. Co.	68985	2,561,700
Metlife Security Ins. Co. of LA	65714	683,568,813
National Affiliated Investores LIC	69370	7,665,896
National American Life Ins. Co.	94412	21,090,618

Other Domiciled Life Companies for Louisiana

Company	NAIC Code	1991 Total Assets
Pan-American Assurance Co.	93459	10,539,687
Paramount Security Life Ins. Co.	76244	3,742,536
Performance Life of America	97209	11,627,787
Reliable Life Ins. Co. of MO	87742	749,319
Rockett Life Ins. Co.	76902	2,905,565
Security Indusrtial Ins. Co.	72117	156,341,775
Southern Financial Life Ins. Co.	69418	6,536,507
Southern Heritage Life Ins. Co.	90891	3,218,413
Trans World Life Ins. Co.	77739	6,138,573
Western Liberty Life Ins. Co.	71064	2,560,105
Western Reserve Life Ins. Co.	68870	360,121
Williams Progressive Life & ACCIC	78344	5,523,103
Winnfield Life Ins. Co.	78352	6,919,610

June 15, 1993
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Mr. HOAGLAND. Mr. Jacobs.

Mr. JACOBS. With the unanimous consent, I hope, of the committee, I would like to present the next witness who is testifying on a bill I have introduced.

He is Andy Larsen. He is the chairman of the Workmen's Compensation Task Force with the National Structured Settlements Trade Association, and also senior vice president of First Colony Life Insurance Co. at Lynchburg, Va.

And, as if that weren't enough, his son, Eric, is one of the tallest guys in his sixth grade class. And, as if that weren't enough, he is the constituent of our colleague, Mr. Payne, to whom I yield.

Mr. PAYNE. Well thank you, Mr. Jacobs, and welcome, Mr. Larsen, to the Ways and Means Committee. I was going to say the Public Works Committee. That is where I was last year.

We appreciate very much the fact that you are here today and appreciate very much what you and First Colony Life Insurance do throughout Virginia. It is one of the most highly regarded corporate citizens certainly in Virginia and throughout Virginia. And certainly your chairman, Ron Dolan, who lives in my home county, now is one of the real community leaders as you are in central Virginia.

Welcome. We thank you for being here and look forward to your testimony.

STATEMENT OF RANDY DYER, EXECUTIVE VICE PRESIDENT, NATIONAL STRUCTURED SETTLEMENTS TRADE ASSOCIATION, AS PRESENTED BY ANDREW LARSEN, CHAIRMAN, TASK FORCE ON WORKER'S COMPENSATION, NATIONAL STRUCTURED SETTLEMENT TRADE ASSOCIATION; AND SENIOR VICE PRESIDENT, FIRST COLONY LIFE INSURANCE CO., LYNCHBURG, VA.

Mr. LARSEN. Thank you very much, Mr. Chairman, Congressman Jacobs, Congressman Payne and members of the committee. We are certainly very pleased to be here today.

The National Structured Settlement Trade Association is an organization of approximately 500 members dedicated to the promotion of structured settlements. Under a structured settlement, a person who has suffered a serious, long-term physical injury from a tort receives damages in the form of periodic payments. These are tailored to his or her special needs, and the payments are made by a financially secure, well-capitalized institution. Congress adopted section 130 of the code to encourage structured settlements and provide financial protection to injured accident victims.

NSSTA very much appreciates the opportunity to testify in strong support of H.R. 1416, introduced by Mr. Jacobs. H.R. 1416 would extend section 130 to include workers' compensation claims.

In adopting section 130, the clear focus of Congress was on providing maximum financial protection and security for the victims of serious, long-term physical injuries.

Thus, the key feature of section 130 is that it permits the obligation to make the stream of damage payments to an injured person to be transferred from the original tort-feasor to a financially secure, well-established institution. The payments to injured victims in these circumstances are funded by two of the safest financial in-

struments available today: United States Treasuries or annuities provided by State-regulated insurance companies.

H.R. 1416 would extend section 130 to cover physical injuries suffered in the workplace as well as those physical injuries now covered by victims of tort claims. It merely adds a parallel class of physical injuries to those already covered by the statute.

A worker who has suffered a severe and permanent injury should have the same access to financial security and stability under section 130 as a tort victim now has. A permanently disabled worker who receives workers' compensation benefits over the next 20 or 30 years has the same valid concerns as a tort victim over relying on the uncertain financial prospects of a self-insured employer who may not even be in business 10 years from now or a weak compensation insurer who threatens to become weaker with time.

The threat of insolvency is real. Many States have no guarantee fund at all to protect injured workers of self-insured employers. Those guarantee funds that do exist are untested in their capacity to respond to a serious insolvency.

Similar concerns exist over troubled compensation carriers. Since 1969, over 200 casualty insurers have failed. A number of the largest failures involved companies that were significant writers of workers' compensation insurance. Several of these companies were located in States represented by members of this subcommittee, such as New York and Massachusetts.

If H.R. 1416 were enacted, the section 130 transaction and worker's compensation would focus on those situations where there is a genuine concern over the continued financial health of a self-insured employer or the compensation carrier and their ability to provide future benefits to permanently injured workers. These seriously injured workers face significant ongoing medical and living expenses and cannot afford to have their compensation delayed, interrupted or completely lost.

If H.R. 1416 were enacted, section 130 would provide maximum financial security to this permanently disabled worker by permitting the responsibility for the 20 or 30 years of compensation payments to be transferred from the troubled employer or compensation carrier to a financially secure institution to be funded out of the safest assets available in the United States today.

All of this also would be overseen and regulated by State workers' compensation authorities. The State authority must approve each and every transfer of payment responsibility. Each case is reviewed by the State authority on its individual facts, and any transfer of payment responsibility must be consistent with the workers' compensation statutes and the best interests of the worker.

For all of these compelling reasons, the National Structured Settlements Trade Association strongly urges the adoption by the Ways and Means Committee of H.R. 1416. H.R. 1416 would enable workers suffering from serious, long-term physical injuries to receive the same high level of financial protection now available to the victims of tort claims.

I thank you and welcome any questions you may have.

Mr. HOAGLAND. OK. Thank you Mr. Larsen.

[The prepared statement follows:]

STATEMENT OF RANDY DYER, EXECUTIVE VICE PRESIDENT OF THE NATIONAL STRUCTURED SETTLEMENTS TRADE ASSOCIATION

My name is Randy Dyer. I am Executive Vice President of the National Structured Settlements Trade Association (NSSTA). I am accompanied today by Andrew Larsen, the Chairman of NSSTA's Task Force on Worker's Compensation.

NSSTA is an organization composed of more than 500 members which negotiate and implement structured settlements of tort cases involving persons with serious, long-term physical injuries. Under a structured settlement, the injured person receives damages in the form of a stream of periodic payments tailored to his or her future medical and basic needs from a well-capitalized, financially-secure institution. This method is chosen over compensation in the form of a lump sum because the lump sum in many cases is prematurely dissipated by the victim who often is ill-prepared for its management. Founded in 1986, the mission of NSSTA is to advance the use of structured settlements as a means of resolving personal injury claims.

NSSTA very much appreciates the opportunity to testify today in strong support of H.R. 1416, introduced by Mr. Jacobs. H.R. 1416 would extend the I.R.C. § 130 qualified assignment of liability mechanism to include worker's compensation claims as well as tort claims, thereby providing to persons who have suffered serious, long-term injuries in the workplace the same financial protection that is currently available to tort victims.

I. Section 130 Adopted to Protect Seriously-Injured Tort Victims

Code section 130 was adopted as part of the Periodic Payment Settlement Act of 1982 (P.L. No. 97-473) to provide a mechanism under which badly-injured tort victims suffering harm well into the future could receive compensation in the form of a stream of payments from a financially-secure and experienced institution.

In adopting section 130, the clear focus of Congress was on providing maximum financial protection and security for a victim who has suffered serious, long-term physical injuries. Providing compensation to the victim in the form of a long-term stream of payments, such as the remainder of his or her life or 20 or 30 years, meets the injured person's medical and living needs over time and guards against premature dissipation of the recovery by the victim. However, the long-lived nature of the payment stream makes the financial health of the payor a vital concern to the injured person.

The section 130 qualified assignment mechanism reflects a Congressional recognition of the perils of leaving a badly-injured person exposed to the uncertain financial prospects of a self-insured tortfeasor or a financially-impaired property and casualty carrier over the next 20 or 30 years. The key feature of section 130 is that it permits the obligation to make the stream of payments to the injured person to be transferred from the tortfeasor (or its insurer) to a well-capitalized, financially-secure institution. Congress expressly mandated in section 130 that the assignee must fund its assigned payment obligation to the injured victim from two of the safest types of investments available -- U.S. Treasury obligations or annuities of state licensed and supervised life insurance companies.

To provide even greater financial security to the injured victim, Congress amended section 130 to permit the victim to be given secured creditor status with respect to these high grade funding assets being used by the assignee to make the periodic payments.

Section 130 includes a series of other requirements, protections, and restrictions regarding the assignment of the periodic payment obligation as well as the assets used to fund the payment obligation, in order to protect the injured victim as well as to ensure that no potential tax concern is raised.

II. Section 130 Rationale Applies Equally to Physical Injuries Suffered in the Workplace

In extending Code section 130 to cover physical injuries suffered in the workplace as well as physical injuries suffered from torts, H.R. 1416 is fully consistent with the original purpose of section 130 and merely adds a parallel class of physical injuries to those already covered by the statute.

All of the important policy reasons underlying the use of qualified assignments for physical injuries in the tort context apply with equal force to a person who has suffered physical injuries in the workplace. The form of making the claim for such physical injuries -- whether in tort or worker's compensation -- should not be a basis for differentiation regarding the availability of the financial protections of section 130 for the seriously injured victim. Indeed, in many cases the worker's compensation statutes require injured workers to forego tort remedies against their employers.

A worker who has suffered a severe and permanent physical injury should have the same access to the financial security and stability offered by the section 130 as tort victims are afforded -- that is, to have the compensation obligation assigned to a well-capitalized and experienced institution which can also provide the injured worker with secured creditor status. A seriously and permanently disabled worker who is to receive a stream of worker's compensation payments over the next 20 or 30 years has the same valid concerns as the tort victim over relying on the uncertain financial prospects of a self-insured industrial employer which may no longer be in business a decade from now or a compensation carrier that is weak and threatens to become more so in the future.

Consider the case of a worker who has been permanently paralyzed from the waist down and will be receiving weekly worker's compensation benefits for a long period of time. His employer is a small construction business that is self insured and has been experiencing rising financial losses. The injured worker may well be motivated to seek a lump sum settlement of the remainder of his claim, fearing that he cannot rely on the future financial health of his employer to continue providing the payments that are necessary for his expensive, ongoing medical care and living needs. In other instances, a financially-precarious employer may use the threat of insolvency to coerce a disabled worker to accept a settlement of his or her claim in the form of a reduced lump sum. A similar fear of the loss of future benefits can arise where the employer's compensation carrier becomes financially impaired. In all of these cases, the specter of risk and uncertainty -- and the fear of having to battle the other creditors of the employer or of the compensation carrier -- can cause the permanently disabled worker to "take the cash" as a lump sum settlement of the remainder of the claim, even though the amount is likely to represent considerably less than he or she would have received in statutory worker's compensation benefits over time.

In the case of threatened insolvency, the state worker's compensation referee who hears all worker's compensation claims and must approve the terms of their resolution would have only two options under current law. The state referee could deny the injured worker's request for a lump sum resolution of the remainder of his claim, exposing the worker to the risk of worsening financial health of the employer or compensation carrier. Alternatively, the state referee could permit a lump sum resolution of the remainder of the injured worker's claim as the best of two poor choices, knowing that continued periodic payments would have been in the best interests of the disabled worker and his or her family who often are ill-equipped to manage a lump sum to provide for medical and basic needs that will extend well into the future.

The concerns over the insolvency of a self-insured employer are very real. Up until the past few years, there were no guarantee funds available to protect the injured workers of self-insured employers. For example, a few years ago a large self-insured supermarket chain in the Southwest failed, leaving approximately 75 workers without any benefits at all. Since the time of the bankruptcy of this employer, these workers have received no payments and are presently pursuing their claims for benefits through the bankruptcy court. Even in the approximately 25 states that have guarantee funds for self-insured employers, the capacity of these funds to respond to a major insolvency is untested. Thus, a state facing the insolvency of a self-insured employer in many cases has few options with which to address these serious long-term disability cases other than to shoulder the burden of worker's compensation claims running 20 or 30 years out or offer these permanently disabled workers lump sum settlements which the workers and their families often are ill-equipped to manage.

Similar concerns exist over the threatened or actual insolvency of casualty insurers. Since 1969, over 200 casualty insurers have failed. Some of the larger insolvencies include the following companies:

Name	State of Domicile	Rank of insolvency
Mission Insurance Co.	California	1st
Transit Casualty	Missouri	2nd
Ideal Mutual Insurance Co.	New York	3rd
American Mutual Liability	Massachusetts	4th
Midland Insurance Co.	New York	5th
Champion Insurance Co.	Louisiana	6th

Four of these companies -- Mission Insurance Co., American Mutual Insurance Co., Ideal Mutual Insurance Co., and Midland Mutual Insurance Co. -- had written a significant volume of worker's compensation coverage. While it is fortunate that in these particular instances the casualty guarantee associations ultimately were able to provide the injured workers with their full benefits, we understand that there were in many cases delays and interruptions in payments. These seriously-injured workers often face significant ongoing medical and living expenses, and hence even delays or interruptions in benefits can create serious problems for these disabled workers. Even the failure of a small carrier can affect many injured workers. For example, Westmoreland Casualty had less than one percent of the overall worker's compensation market in Pennsylvania at the time it was taken over by state regulators in 1987, yet the liabilities associated with worker's compensation claims exceeded $30 million to disabled workers.

If H.R. 1416 were enacted, the most likely section 130 assignment of liability transactions in the worker's compensation context would involve these situations where concern exists about the continued financial ability of a self-insured employer or compensation carrier to provide future benefits to permanently disabled workers. Under the applicable state or federal worker's compensation statute, each resolution of a worker's claim and any assignment of liability for that claim are subject to review by the state worker's compensation referee on an individual case basis under its particular facts. The injured worker must assent to the arrangement, and the state referee must determine that the resolution of the claim and any assignment of liability are consistent with the worker's compensation statute and are in the best interests of the injured worker. State worker's compensation referees historically have demonstrated a strong inclination to have financially healthy employers or compensation carriers retain liability for worker's compensation claims. As a result, assignments of liability by a self-insured employer or by a compensation carrier are likely to be permitted by the state referee in most cases only where there is some demonstrated concern as to the future financial health of the employer or carrier.

If H.R. 1416 were enacted, the availability of the section 130 qualified assignment mechanism would provide maximum financial security to this permanently disabled worker by permitting assignment of the responsibility for the 20- or 30-year stream of payments for medical and living expenses to a well-capitalized, financially-experienced institution. The assignee would fund its obligation to the injured worker out of the very high grade assets mandated by Congress in section 130 -- U.S. Treasury obligations or annuities of state licensed and regulated life insurance companies. Section 130 would enable the assignee to provide the injured worker with secured creditor status in respect of these high quality assets, thereby giving the worker the maximum financial protection that his or her future medical and other needs will be met. State worker's compensation referees would welcome this additional option for addressing the situation of the financially troubled employer or compensation carrier.

Conclusion

The National Structured Settlements Trade Association strongly urges the adoption by the Ways and Means Committee of H.R. 1416. H.R. 1416 would enable workers suffering from serious, long-term physical injuries to receive the same high level of financial protection now provided to tort victims, by extending section 130 to worker's compensation claims.

Mr. HOAGLAND. Mr. Crispin.

STATEMENT OF ROBERT W. CRISPIN, VICE CHAIRMAN AND CHIEF INVESTMENT OFFICER, THE TRAVELERS CORP., HARTFORD, CONN.

Mr. CRISPIN. Mr. Chairman, members of the committee, I am Robert Crispin, vice chairman and chief investment officer of the Travelers Corp. of Hartford. I want to thank the subcommittee today for providing me this opportunity to appear before you regarding a matter of significant interest to us.

I am responsible for the investment management of the company's assets, including stocks, bonds, and real estate. Earlier this year, we announced our intention to accelerate the sale of a significant portion of foreclosed real estate properties that we hold resulting from the drastic and sustained downturn in commercial real estate markets throughout the country. Our decision to dispose of those assets will improve our profitability and allow us to redirect the proceeds into sectors of the economy in need of credit.

We will also eliminate significant carrying costs on those assets and earn current income upon their reinvestment.

As part of our effort to dispose of foreclosed real estate, I have become aware of a special provision of the Internal Revenue Code that requires life insurance companies to undertake extraordinary tax-planning steps to time and to structure those dispositions. This coordination must be done to receive a current tax benefit for the economic loss that will be realized on the sale of those assets.

We believe that there is no tax policy justification for the rule. Moreover, its existence unduly complicates the disposition program.

No taxpayers, other than life insurance companies, are affected by this provision. Other businesses are allowed the benefit of any loss they realize on the sale of their business property without undertaking the additional and noneconomical steps that life insurance companies are forced to take solely as a result of the provision.

That provision I am referring to is section 818(b) of the Internal Revenue Code. Essentially, it provides that a life insurance company selling at a loss any depreciable property or real property used in any trade or business other than its life insurance business must treat the loss as a capital loss. Other taxpayers who dispose of identical properties at a loss are allowed an ordinary loss.

Capital losses of a corporation are deductible only to the extent the corporation has realized capital gains, and capital losses obviously expire after 5 years.

On the other hand, ordinary losses can be used to offset either capital gain income or ordinary income. Therefore, for the Travelers to receive the tax benefit of a loss it realizes on the sale of foreclosed properties, we must match the overall capital gain and capital loss position. To do that, we must either slow down the pace of the disposition of the real estate or speed up the sale of bonds with capital gains. And other taxpayers who are not subject to 818(b) do not have to make those types of investment decisions strictly for tax reasons.

Now, we at the Travelers have sufficient appreciated capital assets in our total portfolio of investments so that we are confident

that none of the capital losses would go unused. But, as a matter of sound business judgment, we will see to it that we will fully utilize those losses.

But pursuing that strategy is not without cost to us. We incur transaction costs each time we are forced to accelerate a sale to generate capital gains, and such sales result in the sale of high coupon bonds which we replace with lower yielding instruments. These trades hurt future year's operating income and, by the way, decrease our future taxable income.

Section 818(b) is a vestige of the now thoroughly discredited Life Insurance Tax Act of 1959, which Congress repealed, thankfully, in 1984. And whatever the merits of section 818(b) under that 1959 act, its reason for being expired with the complicated three-phase tax system of that act.

In my view, there is no justification for preserving the special section rule treating nonlife insurance trade or business assets as capital assets when all other taxpayers treat such assets as ordinary income assets.

For the above reasons, I believe that it is appropriate to repeal 818(b), and, by doing so, Congress would be allowing life insurance companies the same tax treatment of business assets that other taxpayers have under the code. I know if section 818(b) is repealed, we will be allowed to make decisions based on their investment and economic merits rather than tax considerations.

Thank you very much, Mr. Chairman.

Mr. HOAGLAND. Thank you, Mr. Crispin.

[The prepared statement follows:]

WRITTEN STATEMENT OF THE TRAVELERS CORPORATION BEFORE THE COMMITTEE ON WAYS AND MEANS SUBCOMMITTEE ON SELECT REVENUE MEASURES

I. **INTRODUCTION.**

I am Robert W. Crispin, Vice Chairman and Chief Investment Officer of The Travelers Corporation. I want to thank the Subcommittee for providing this opportunity to appear before you today regarding a tax matter of some importance to my company.

As Chief Investment Officer of The Travelers, I am responsible for the investment management of the company's assets including securities and real estate. Travelers announced in February 1993 its intention to accelerate the sale of a significant percentage of the foreclosed real estate properties that we hold. The drastic and sustained downturn in the commercial real estate market has left Travelers holding foreclosed real estate with a book value of approximately $2 billion. We have made a business decision that disposing of a significant percentage of those assets will improve our profitability by eliminating carrying costs, and will allow our management to refocus on our core business of insurance underwriting. We sold more than $285 million in foreclosed real estate last year, and already this year we have sold more than $64 million of foreclosed properties.

II. **TAX TREATMENT OF FORECLOSED PROPERTY SALES MADE BY LIFE INSURANCE COMPANIES.**

A. **Current Law.**

As part of our effort to dispose of foreclosed real estate, I have become aware of a special provision of the Internal Revenue Code that requires us, as a life insurance company, to undertake extraordinary tax planning steps regarding the timing and structure of our dispositions in order to receive a current tax benefit for the economic loss that we realize on these properties. Not only does this special tax provision complicate our disposition program, but we believe that there is no tax policy justification for the continuation of the rule. No taxpayers, other than life insurance companies, are affected by this provision. Other businesses are allowed the benefit of any loss they realize on the sale of their business property, without undertaking the additional, and non-economical, steps that life insurance companies are forced to take solely for tax purposes.

The provision to which I am referring is section 818(b) of the Internal Revenue Code of 1986, as amended (the "Code"). Essentially, it provides that a life insurance company selling at a loss any depreciable property or real property used in any trade or business other than its life insurance business must treat the loss as a capital loss. Other taxpayers who dispose of the identical kinds of properties at a loss are allowed an ordinary loss, as the following technical analysis shows.

Section 1221 of the Code excludes certain property from the term "capital asset." Under section 1221(2), depreciable property used in a trade or business and real property used in a trade or business do not qualify as capital assets.

Under a special rule provided in section 1231, if gains from the sale or exchange of real or depreciable property used in a trade or business and held for more than one year exceed the losses from the sale or exchange of such property for the taxable year, the net gain is treated as capital gain. If losses from the sale or exchange of such property exceed the gains from the sale or exchange of such property for the taxable year, the net loss is deductible as an ordinary loss.

Section 818(b) modifies section 1221(2) and section 1231 of the Code, as those sections relate to life insurance companies. In the case of a life insurance company, section 818(b) provides that for purposes of applying section 1231(a), the term "property used in the trade or business" includes only depreciable or real property used in carrying on an insurance business. In the case of a life insurance company, section 818(b) provides that for purposes of applying section 1221(2), the reference to property used in a trade or business is treated as including only property used in carrying on an insurance business.

As a consequence of section 818(b), any non-insurance trade or business asset, which otherwise would not constitute a capital asset, that is sold by an insurance company at a loss results in a capital loss.

It is generally more advantageous from a tax standpoint to have an ordinary loss rather than a capital loss. The capital losses of a corporation are deductible only to the extent the corporation has realized capital gains, and capital loss carryforwards expire after five years. On the other hand, ordinary losses can be used by a corporation to offset either capital gain income or ordinary income. Therefore, for The Travelers to receive the immediate tax benefit of a capital loss it realizes on the sale of foreclosed properties, The Travelers must monitor its overall capital gain and capital loss position throughout its entire asset portfolio, to ensure that it will realize capital gain each year at least equivalent to its capital losses for the year. To match capital gains with capital losses, The Travelers can either slow down the pace of its sales of real estate, or speed up sales of assets with capital gains in its bond portfolio. Other taxpayers, who are not subject to section 818(b), do not have to make those types of investment decisions strictly for tax purposes.

B. Added Costs Due to Section 818(b).

The Travelers has sufficient appreciated capital assets in our portfolio of investments so that we are confident that none of our capital losses will go unused. As a matter of sound business judgment, we will see to it that we fully utilize the losses. However, pursuing that strategy is not without cost to us. We incur transaction costs each time we are forced to accelerate a sale to generate capital gain solely for tax reasons. Those tax-driven sales also result in our selling high coupon bonds and replacing them with lower yielding instruments, which hurts our future years' operating income, and by the way, decreases our taxable income. Tax-driven sales also distort our carefully balanced investment portfolio, which is designed to generate cash flows at the times that we expect to pay out benefits to policyholders. Therefore, although we can plan around section 818(b), section 818(b) has real costs to us.

C. Section 818(b) Has No Rationale and Should Be Repealed.

Section 818(b) is a vestige of the Life Insurance Company Income Tax Act of 1959, a tax scheme which is now universally recognized as irrational and unworkable. Former Code section 817(a) of the Code, which was the predecessor of section 818(b), was enacted to avoid the complexity of including sales on non-insurance property in the three-phase tax system inaugurated by the Life Insurance Company Income Tax Act of 1959. The extremely complex three-phase system was eliminated by the Tax Reform Act of 1984. The overall objective of the 1984 Act was to tax life insurance companies in a manner comparable to that applicable to other corporations.

As a result of the 1984 repeal of the Life Insurance Company Income Tax Act of 1959, there is no longer any basis for

preserving the special section 818(b) rule regarding the treatment of capital assets. Consistent with the objective of the 1984 Act, the character of a life insurance company's gain or loss on the sale of real estate or depreciable property should be determined under the same general rules of section 1221 and 1231 that apply to other businesses. Section 818(b), therefore, is a section which should be repealed.

Conceptually, the foreclosed real estate properties that The Travelers actively manages as a trade or business are appropriately classified as non-capital assets under section 1221(2) of the Code. A sale or disposition of a non-capital asset at a loss is an ordinary loss, just as the rental income we report from the rentals of the properties are ordinary income. I do note that for tax purposes depreciable property and real property used in a trade or business are placed in a special category known as "section 1231 assets," which receive dual treatment under the Code. If a taxpayer has a net loss on the sale of section 1231 assets during a taxable year, the net loss is deductible as an ordinary loss. On the other hand, if there is a net gain on sales of section 1231 assets for the year, the net gain is treated as a capital gain and taxed at the capital gain rate. Because the corporate tax rate on capital gains is now the same as the corporate tax rate on ordinary income, section 1231 today has little consequence to taxpayers. However, the section 818(b) rule, which denies life insurance companies ordinary loss treatment on the sale of what otherwise would qualify as section 1231 assets, has a real consequence. Unless the life insurance company actively takes special steps to ensure that it realizes sufficient capital gains, a section 818(b) capital loss may not be usable in the year it is realized.

D. **Repeal of Section 818(b) is Likely to Be Revenue Neutral.**

A repeal of section 818(b) is likely to have a minimal impact on federal tax revenues as a result of several factors. First, the life insurance industry in recent years has realized a large amount of net capital gains which are available for offset by capital losses, under the carryback rules. Second, virtually all members of the life insurance industry have substantial unrealized capital gains available to offset capital losses which are likely to be realized in the 5-year time horizon. Third, the insurance industry is limited in its ability to accelerate capital loss realizations even if, as a result of a repeal of section 818(b), such realization would be available to offset ordinary income. Fourth, many members of the insurance industry can utilize tax planning strategies to avoid adverse consequences under section 818(b).

1. **Discussion of Factors Contributing to Revenue Neutral Impact From Repeal of Section 818(b).**

a. **Recent High Level of Realized Net Capital Gains.**

While historically the life insurance industry generally nets its capital gains and losses each year, for the past several years life insurance companies actually have reported substantial realized net capital gains on an aggregate basis. The latest industry data indicate that life insurance companies reported over $11 billion in net realized capital gains for the years 1990 through 1992.

Current law allows taxpayers to carry back realized capital losses three years to offset realized capital gains. As a result, even in the absence of a repeal of section 818(b), it is anticipated that any realized losses within the foreseeable future, which are treated as capital losses solely as a result of section 818(b), will produce a full tax benefit as a result of the ability to carry back these losses against previously taxed

realized net capital gains. Thus, even if section 818(b) is repealed and ordinary loss treatment is available, there would likely not be any change in federal revenues.

b. **Current High Level of Unrealized Capital Gains.**

In addition to the substantial realized net capital gains available in the three year carryback period, another factor suggests that the repeal of section 818(b) is unlikely to affect current federal tax revenues. Specifically, the life insurance industry currently has substantial unrealized built-in capital gains in its companies' existing portfolios as a result of falling interest rates within the past 12-month period affecting its bond portfolios and a continuing rise in the stock market affecting its equity investments. As a result of these substantial unrealized gains, it is anticipated that the life insurance industry will continue to realize net capital gains for the foreseeable future consistent with recent experience. Thus, even in the absence of a repeal of section 818(b), it is likely that any realized losses within the foreseeable future, which are treated as capital losses solely as result of section 818(b), will produce a full tax benefit.

c. **Limited Ability to Accelerate Capital Losses.**

In the event that section 818(b) is repealed, some concern might be raised that the life insurance industry would accelerate its disposition of section 1231 properties to produce a net tax benefit. This concern is unjustified for at least two reasons. First, the life insurance industry is limited in its ability to accelerate capital losses. The heavily-regulated life insurance industry operates under strict capital and surplus requirements. Realizing capital losses would decrease a company's available capital and surplus. As a result, accelerating capital losses for tax purposes is simply not an option for insurance companies facing surplus pressures. In fact, the high level of capital gain realizations over the past few years is a direct result of the need of life insurance companies to increase their surplus levels.

A second reason suggesting that life insurance companies will not be able to accelerate disposition of properties to trigger ordinary losses in the event of a repeal of section 818(b) concerns the business strategies which have been adopted by these companies. In many cases, to accelerate disposition of these properties would require a substantial change in business strategy which would be inconsistent with the overall investment strategy which these companies have put in place for non-tax reasons. As a result, any such change would have to produce substantial benefits in order to be justified.

d. **Self-Help Techniques Are Already Available to Some Life Insurance Companies.**

A final factor suggesting that the repeal of section 818(b) will not produce a net federal loss of revenue relates to the fact that at least some life insurance companies with significantly troubled real estate assets have already been able to avoid the adverse consequences of section 818(b) through self-help techniques. For instance, within the context of a consolidated group of corporations, an insurance company can transfer foreclosed real estate and other assets that otherwise are subject to section 818(b) to non-life affiliates, which can claim ordinary losses under the normal rules of the Code when they dispose of the assets outside of the group. These techniques, however, are not available to all life insurance companies due to the fees incurred to transfer real estate properties within a consolidated group and as a result of the impact which such transfers may have on capital and surplus of the life insurance company.

III. **CONCLUSION**.

For the above reasons, I believe that it is appropriate to repeal section 818(b) of the Code. Congress should allow life insurance companies the same tax treatment of business assets that other taxpayers have under the Code. I know if section 818(b) is repealed, it will simplify my company's tax planning, and allow us to make decisions regarding asset sales based on economic factors, rather than tax considerations.

I want to thank you again for the opportunity to appear before the Committee and I request your support regarding the repeal of section 818(b).

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Mr. HOAGLAND. Mr. Teasley.

STATEMENT OF LARKIN TEASLEY, PRESIDENT AND CHIEF EXECUTIVE OFFICER, GOLDEN STATE MUTUAL LIFE INSURANCE CO., LOS ANGELES, CALIF., ON BEHALF OF NATIONAL INSURANCE ASSOCIATION

Mr. TEASLEY. Mr. Chairman and members of the subcommittee, I want to thank you for the opportunity to discuss with you two very important tax changes that will ease the burden on small life insurance companies.

The continuing viability of small insurance companies is essential if we are to improve poor socioeconomic conditions in the United States. Small insurance companies serve low and lower-middle income communities that larger firms ignore.

I am Larkin Teasley, president and CEO of Golden State Mutual Life Insurance Co. I am testifying on behalf of our company and also on behalf of the National Insurance Association. Golden State Mutual is based in Los Angeles. It has surplus and capital of approximately $9 million.

The National Insurance Association is comprised of small African-American companies serving African-American communities throughout the United States. While the size of the average policy issued by firms not in the association is over $80,000, members of the National Insurance Association have average policies in the range of $3,000 to $5,000.

Now, the first proposal would allow the deduction available to small life insurance companies to be used when calculating a small company's adjusted current earnings for purposes of the alternative minimum tax.

The second would exempt certain small companies from the requirement under Internal Revenue Code section 848 to capitalize specified insurance policy acquisition expenses.

These two small life insurance company provisions fit in with the theme of the tax bill being developed by Congress this summer. We need to structure the Tax Code in such a way as to encourage competition and job growth in areas that are too frequently ignored by investors seeking only short-term profits.

Now, the life insurance industry is dominated by a small number of huge companies, and these companies are better able to allocate their fixed costs, whereas smaller firms cannot do so.

The first proposal would allow the deduction available to small life insurance companies to be used when calculating a small company's adjusted current earnings for purposes of the alternative minimum tax. Out of the minimum tax adopted in 1986, the small life company deduction is treated as a preference item, meaning that the benefit of the provision adopted in 1984 is either reduced or eliminated. The solution to this problem is to allow the small life company deduction to be used when calculating adjusted current earnings.

The second provision described in the press release would exempt certain small companies from the requirement under IRS Code section 848 to capitalize specified insurance policy acquisition expenses. Specifically, the provision would not apply to firms with an-

nual statement surplus and capital of less than $25 million or specified policy acquisition expenses of less than $4 million.

Section 848 was adopted as part of the 1990 Omnibus Budget Reconciliation Act. Under prior law, companies expensed acquisition costs in the first year that a policy was in force.

The capitalization of acquisition expenses remains extremely burdensome to all small life insurance companies. Small companies incur certain fixed expenses similar to those incurred by all insurers. Accordingly, profit margins are slim.

The additional tax burden placed on small life insurance companies as a result of the specified policy acquisition expense provision makes writing profitable business difficult. The solution is to exempt companies writing a sufficiently low premium volume, such that less than $4 million of policy acquisition expenses is generated or companies with less than $25 million of capital and surplus.

We thank you very much for considering these two proposals. Thank you.

[The prepared statement follows:]

Testimony of Larkin Teasley
President and Chief Executive Officer
Golden State Mutual Life Insurance Company
On Behalf of National Insurance Association

House Ways and Means Select Revenue Measures Subcommittee
Hearing on Miscellaneous Revenue Measures
Thursday, June 17, 1993

Mr. Chairman, Members of the Subcommittee, I want to thank you for the opportunity to discuss with you two tax law changes that would ease the tax burden on small life insurance companies, allowing them to continue to compete effectively with the larger firms and to serve communities that the larger firms frequently ignore.

I am Larkin Teasley, President and Chief Executive Officer of Golden State Mutual Life Insurance Company. I am testifying on behalf of Golden State and on behalf of the National Insurance Association. Golden State is based in Los Angeles, California. Operations are conducted in 22 states and the District of Columbia on a combination branch office and general agency basis. The company maintains 18 branch offices and nearly 410 general agencies and is represented by a field office of about 626 managers and agents. It offers a complete portfolio of ordinary, group, and monthly industrial life insurance. A substantial volume of group and individual health coverage is also written. Golden State wrote about $15.5 million in premiums in 1991.

The National Insurance Association (NIA) is comprised of small African-American companies serving African-American communities throughout the United States. While the size of the average policy issued by firms not in the association is over $80,000, Golden State's average policy is for between $12,000 and $15,000. Other members of NIA have average policies in the range of $3,000 to $5,000. Many association members still follow the practice of collecting premium payments at the homes of the policyholders.

The two proposals for which I want to testify are described under the insurance provisions (Item 1) listed on Page 2 of the Select Revenue Measures subcommittee's June 2 press release (Press Release #4).The first proposal would allow the deduction available to small life insurance companies to be used when calculating a small company's adjusted current earnings for purposes of the alternative minimum tax. The second would exempt certain small companies from the requirement under Internal Revenue Code Section 848 to capitalize specified insurance policy acquisition expenses. Specifically, this exemption would apply to firms with annual statement surplus and capital of less than $25 million or specified policy acquisition expenses of less than $4 million annually.

I'll describe these provisions in more detail in a minute. But, first, I just want to explain briefly why such provisions are needed and why they fit in with the theme of the tax bill being developed by Congress this summer. President Clinton emphasized during his election campaign the need to make investments in order to get the economy moving again. In particular, he stressed the need to put people first by favoring strategies that create jobs. That's why this bill would extend the targeted jobs tax credit and that's why it calls for creation of empowerment zones and enterprise zones. We need to structure the tax code in such a way as to encourage competition and job growth in areas that are too frequently ignored by investors seeking only short-term profits.

That's what these two small insurance company provisions are all about. The life insurance industry is dominated by a small number of extraordinarily large enterprises that control multibillion dollar asset portfolios. ***Since these large firms can allocate their fixed costs over a far larger pool of customers, its extremely difficult for small firms to compete in this industry.*** Of course, most minority-owned firms fall into this category. Minority firms can compete in this industry if they are put on an equal footing with the large firms that control it. But a tax law that is blind to differences between large and small life insurance companies allows the small, minority-owned, start-up firms little hope of survival.

Fortunately, Congress has long recognized the pressing need for tax provisions to give small insurance firms a fighting chance to be competitive. Small insurance companies deserve this consideration because they have a harder time meeting reserve requirements than larger firms. However, ***several recent changes in the insurance law were***

adopted without much thought being given to how they would affect the delicate balance between large and small insurance companies. The two insurance provisions described in the subcommittee's June 2 press release are aimed at restoring this balance to the tax law.

The first proposal would allow the deduction available to small life insurance companies to be used when calculating a small company's adjusted current earnings for purposes of the alternative minimum tax. When Congress rewrote the rules for taxation of life insurance firms in the Tax Reform Act of 1984, lawmakers recognized that a special deduction was needed if small insurance firms were to remain competitive. Thus, that law includes a small insurance company deduction of 60 percent of tentative life insurance company taxable income for a taxable year that does not exceed $3 million. The deduction is reduced by 15 percent of the excess of tentative life insurance company taxable income over $3 million. Accordingly, the maximum deduction that can be claimed by a small company is $1.8 million, and a company with tentative life insurance company taxable income of $15 million or more would not be entitled to any small company deduction.

Problems arose with enactment of the corporate alternative minimum tax as part of the Tax Reform Act of 1986. This provision effectively overrode the Congressional intent relating to small insurers as expressed in the legislative history to the 1984 Act--to help such firms compete with the much larger companies dominating the industry. Consider what the Joint Committee on Taxation staff "bluebook" description of the 1984 law said about the decision to adopt a small life-insurance company deduction. The bluebook description of a controlled group rule explained that "As in the case of the special life insurance company deduction, the Congress believed that, without this provision, the Act provided for the proper reflection of taxable income. Nonetheless, the Congress recognized that small life insurance companies have enjoyed a tax-favored status for some time, and believed that it would not be appropriate to dramatically increase their tax burden at this time." Under the minimum tax adopted in 1986, the small company deduction is treated as a preference item, meaning that the benefit of the provision adopted in 1984 is either reduced or eliminated. The solution is to allow the small company deduction to be used when calculating adjusted current earnings.

It's important to remember some of the unique aspects of the insurance business. Life insurance polices are long-term, fixed-price contracts. Firms cannot alter the premium structure of policies in effect, nor can they cancel the contracts. ***It's hard to think of any other industry that depends on an income stream which cannot be adjusted to reflect changes in costs.*** The only way that a firm can cover for losses brought on by poor claims experience or other unexpected factors is to charge more for future policies, with severe consequences in a very competitive industry. It's easy to see why most insurance companies are so large. Such firms can spread their losses over a very large group of policies. The tax benefit for small firms goes a long way toward making up for this difference in the competitive prospects of the two types of firms.

Another factor worth keeping in mind is that the small company deduction is calculated as a percentage of an eligible company's otherwise taxable income. The deduction can only reduce a firm's tax rate, but can never produce a loss. Thus, there is no risk of this provision leading to creation of tax shelters. Indeed, ***the proposed change would make the insurance industry more competitive, producing all the economic efficiencies that go along with such a change.*** The alternative is an industry dominated by large firms, one providing less access to start-up firms in general and minority firms in particular, and a loss of the creative energy shown by small firms in the regular introduction of new consumer-oriented products.

The second provision described in the press release would exempt certain small companies from the requirement under Internal Revenue Code Section 848 to capitalize specified insurance policy acquisition expenses. Specifically, the provision would not apply to firms with annual statement surplus and capital of less than $25 million or specified policy acquisition expenses of less than $4 million annually.

Section 848 was adopted as part of the Omnibus Budget Reconciliation Act of 1990. Under prior law, companies expensed acquisition costs--such as agent commissions, policy underwriting costs, and premium taxes--in the first year that a policy was in force. The new rules generally require insurance companies to capitalize and amortize their specified policy acquisition expenses on a straight-line basis over 120 months. However, insurers are allowed a 60-month amortization period for the first $5 million of specified policy acquisition expenses in any taxable year. The amount of capitalized costs eligible for this shorter amortization period is phased out on a dollar-for-dollar basis as the specified policy acquisition expenses of the insurance company exceed $10 million. Thus, the shorter amortization period is not available as specified policy acquisition expenses equal or exceed $15 million for a taxable year.

Small life insurers receive this modest tax benefit of more rapid amortization because Congress wanted to encourage small business and competition in the marketplace for insurance policies. While Section 848(b)--the provision that allows insurers with less than $5 million of specified policy acquisition expenses to amortize costs over 60 months rather than 120 months--is favorable, even with the more rapid amortization, the capitalization of acquisition expenses remains extremely burdensome to a small life insurance company. For example, a ***company writing only $52 million of ordinary life insurance premiums usually will generate about $4 million of specified policy acquisition expenses that must be capitalized and amortized.***

Small companies incur certain fixed expenses similar to those incurred by all insurers. Accordingly, profit margins are slim. ***The additional tax burden placed on small life insurance companies as a result of the specified policy acquisition expense provision makes writing profitable business difficult.*** The solution is to exempt companies writing a sufficiently low premium volume that less than $4 million of specified policy acquisition expenses is generated.

Thank you for considering these proposals. I'll be glad to answer any questions that you might have.

Mr. HOAGLAND. Thank you, ladies and gentlemen, for your thoughtful statements. I am afraid we are going to have to recess again for 15 minutes because it looks like we are going to have two votes.

Mr. Jacobs, do you have a question of any of the panelists?

Mr. JACOBS. Well, the only thing I wanted to mention for the record is that I think there is a revenue estimate on this structured settlement in this bill that is quite questionable. The present revenue impact is $50 million a year for the vast area of tort recoveries. And now in the relatively smaller area of recoveries that might be used by this law in workmens' compensation, they are saying it is something like four or five times that much. I think somebody's pencil slipped off the lead or something, and I think we ought to talk to the Joint Committee about that a little bit.

Mr. HOAGLAND. Isn't there a good chance this issue will be wrapped into the Clinton proposal?

Mr. LARSEN. That I think is unclear really at this time. But I would add to Congressman Jacobs' comments that we have been working closely with the staff of the Joint Committee and will continue to do that.

Mr. JACOBS. Just one other thing that I wanted to point out.

A couple of years ago when we extended section 130, the administration came up here with a $10 trillion cost impact, and in about 72 hours they revised their figures to $50 million. So this has had a history of rather strange analysis, and I think we possibly have one on hand now. It is a good bill.

Mr. HOAGLAND. Well, thank you everyone, for coming. We appreciate your testimony.

The committee will stand in recess for 10 to 15 minutes.

[Recess.]

Mr. HOAGLAND. The hearing will come to order.

Now I would like to welcome panel four. We have Lynda Kern, representing the American Bankers Association; Louis Eliasberg, representing the Commercial Finance Association; David Manning with the Community Bankers Association of Illinois; and Don Susswein with the Coalition for Asset Backed Securities.

I certainly welcome the four of you to the committee this afternoon, and we appreciate you taking the time to testify. We have yet two panels to go after this one, so, once again, I would ask you to try and keep your comments to 3 minutes, if you can. And explain the concepts in plain language so that the nontax lawyers on the panel can understand the concepts involved.

Why don't we begin with Lynda Kern with the American Bankers Association? Ms. Kern.

STATEMENT OF LYNDA A. KERN, CHAIRPERSON, TAXATION COMMITTEE, AMERICAN BANKERS ASSOCIATION, AND VICE PRESIDENT-TAXATION, AMSOUTH BANK N.A., BIRMINGHAM, ALA.

Ms. KERN. Yes, sir.

Congressman Hoagland and members of the subcommittee, my name is Lynda Kern. I am from AmSouth Bank in Birmingham, Ala., and I am testifying today in my role as chairperson of the American Bankers Association Taxation Committee.

My testimony will focus on tax legislative changes, each of which will facilitate the banking industry's ability to support the economic recovery in several areas. The proposals involve the opportunities for banks to provide our customers with better returns on savings investments, to improve the availability of credit to small businesses and to small municipalities, and to relieve some of the stress of bank holdings of foreclosed real estate. We believe that each of these changes will encourage economic activity and contribute to the Nation's recovery.

First, the ABA strongly supports common trust fund conversion legislation which will permit banks to convert their common trust funds into mutual funds, without triggering the consequences of a taxable exchange to the trust fund participants. This legislation is important because it will provide our bank customers with expanded options for investing their savings and thereby allow banks to be more competitive.

Small- and medium-sized banks which have common trust funds will be better able to achieve the economies of scale necessary to justify the cost of and assure the success of a proprietary mutual fund.

Larger institutions, which have a broad customer base, have already set up proprietary mutual funds and successfully marketed products which have produced strong returns for the customers.

For example, my bank, AmSouth in Birmingham, provides an array of four mutual fund choices, and a proprietary mutual fund. For the past year, we have had results which have ensured it as a leading mutual fund in the country. This has allowed all of our customers to have the choice of benefiting from AmSouth's expertise as a money manager without having to set up a trust account.

We have also had strong customer interest in a mutual fund of tax-exempt assets. We need, however, to be able to convert our common trust fund which has a fairly substantial investment in tax exempts in order to have the assets available to form a mutual fund.

This proposal was passed by Congress twice last year and should merit your continued support as a way for savers to conveniently maximize their return in the current low-interest-rate environment. ABA also supports conversion of a common trust fund into more than one mutual fund.

ABA supports a second proposal, contained in legislation introduced by Representatives Hoagland and Shaw, H.R. 2065, to simplify the requirements to turn a pool of commercial loans into marketable securities. This bill is the natural extension of the existing REMIC provisions to cover securities backed by loan assets such as business loans, auto loans and credit card receivables. Moreover, it is an important tax component necessary to fully put in place the efforts in both the House and Senate Banking Committees to stimulate more small business lending.

ABA supports two additional proposals scheduled for a later hearing, one, to raise the cap for bank-qualified municipal bonds to $20 million, which was passed by the Ways and Means Committee last year, and, second, a classification of the at-risk rules as they affect bank financing of properties acquired through foreclosure.

I would like to thank you for the opportunity to testify. We believe we have demonstrated in our testimony that relatively small changes in the tax law can significantly improve investment choices for our customers, enhance the experimentation in the secondary market for small business loans, assist financing for small communities and reduce the burden of foreclosed property on banks in depressed areas. We believe that these changes will contribute in some measure to the health of the national economy.

Thank you.

Mr. HOAGLAND. Ms. Kern, I notice you did not have an opportunity to elaborate fully on your fourth point, but we will certainly make your entire statement part of the record. I apologize for the limitations that the 3 minutes imposes.

[The prepared statement follows:]

TESTIMONY OF LYNDA A. KERN

on behalf of the

AMERICAN BANKERS ASSOCIATION

before the

SUBCOMMITTEE ON SELECT REVENUE MEASURES

U.S. HOUSE OF REPRESENTATIVES

June 17, 1993

Chairman Rangel and Members of the Subcommittee, my name is Lynda A. Kern, Vice President-Taxation, AmSouth Bank NA, Birmingham, Alabama. I am pleased to appear today in my role as Chairperson of the American Bankers Association (ABA) Taxation Committee and a member of the ABA's Government Relations Council. The ABA is the national trade and professional association for America's commercial banks. ABA members include banks of all types and sizes -- money center, regional and community banks, representing approximately ninety percent of the total industry assets.

There has been considerable concern throughout the country about the health of the economy and the scope and strength of the recovery. While there are many factors affecting the economic performance, one important component of our economic well-being involves the availability of credit, especially to small businesses. ABA believes that the most critical factor affecting the availability of credit is the regulatory burden that has been placed on the small business lending process, both on the commercial banks and on their small business customers. Efforts by the Clinton Administration to reduce the paperwork and regulatory burden in this process will be very helpful. In addition, legislation pending in both Houses of Congress, notably H.R. 962, will make further progress in reducing unnecessary regulatory burden on commercial bank lending.

Mr. Chairman, my testimony today will focus on four tax legislative changes, each of which involves modest revenue costs, and which will also facilitates the banking industry's ability to support the economic recovery in several areas. The proposals involve the opportunities for banks to provide bank customers with better returns on savings investments, to extend credit to small businesses and to small municipalities and to relieve some of the stress in the real estate markets. We believe that each of these changes will encourage economic activity and contribute to the nation's economic recovery.

The ABA strongly supports common trust fund conversion legislation which permits banks to convert their common trust funds into mutual funds, without triggering the consequences of a taxable exchange to the trust fund participants. This legislation is important because it will provide bank customers with more options for investing their savings and thereby allow banks to be more competitive. Medium size and smaller banks which have common trust funds will be better able to achieve the critical mass of assets necessary to justify the cost of and assure the success of a proprietary mutual fund. This provision was passed twice last year and should merit your continued support as a way for savers to conveniently maximize their return in the current low interest rate environment. ABA also supports conversion of a common trust fund conversion into more than one mutual fund.

ABA supports a second proposal, contained in legislation introduced by Reps. Hoagland and Shaw, H.R. 2065, to simplify the requirements to turn a pool of commercial loans into marketable

securities. This bill is the natural extension of the existing REMIC provisions, to cover securities backed by loan assets such as business loans, auto loans and credit card receivables. Moreover, it is an important tax component necessary to fully put in place the efforts in both the House and Senate Banking Committees to stimulate more small business lending.

Third, ABA supports a proposal to enhance the ability of commercial banks to buy municipal bonds issuer by small communities, school districts and other issuers of municipal debt which because of their small size, do not have established markets other than sales to their local banks. In 1986, banks were effectively precluded from the municipal bond market, except in the case of municipalities and other issuers which borrow less than $10 million per year. The proposal before the Subcommittee would raise that figure to $20 million, which was passed by the Ways and Means Committee last year. The infrastructure, public education and public safety needs of the small communities continue to grow, making the increase in the ceiling more urgent than ever, so that banks can improve their commitment to support their local government financing.

Finally, ABA encourages the Subcommittee to support a clarification of the at-risk rules to provide that bank financing of properties acquired through foreclosure would be treated like third party financing. Banks which find it difficult to sell off the properties because of depressed real estate markets face an added difficulty, in a form of a tax penalty, when they attempt to finance the sale of foreclosed property. The "at-risk" rules were enacted to stem abuses which arise primarily in private, unregulated transactions, not sales of properties by regulated lenders subject to appraisal law requirements. Congressman Shaw introduced a bill last year which would treat sales by regulated lenders as satisfying the requirements for an exception to the "at risk" rules. Facilitating bank sales of foreclosed properties will stabilize the local real estate markets and reduce costs which presently act as a drag on capital and thereby impede bank lending.

CONVERSION OF BANK COMMON TRUST FUNDS TO MUTUAL FUNDS

Many banks would like to be able to convert their common trust funds to mutual funds in order to provide expanded investment choices for both their trust and non-trust customers. In a conversion, the assets of the bank common trust fund are transferred to a proprietary mutual fund, to which in many cases the bank may serve as investment advisor, performing the same money management function that it had for the common trust fund. Unfortunately, the conversion is effectively blocked because the bank trust customers would have to pay tax on any gains in the trust account at the time of the conversion. Bankers would find it difficult to justify having that cost imposed on trust participants because they owe a fiduciary duty to their customers.

Congress concurred that this problem should be resolved, by passing twice last year legislation to permit a common trust fund to be converted to a mutual fund without triggering the tax consequences of a exchange to the trust and its participants. When that legislation was not enacted into law last year, Chairman Rostenkowski reintroduced it this year as Section 623 of H.R. 13. The legislation protects the customer from having to pay tax before cashing out the investment. The legislation preserves the revenue, however, by requiring tax be paid at such time as the mutual fund investment units are sold.

The ABA strongly supports this legislation because it will help medium size and smaller banks which have common trust funds to achieve the critical mass of assets necessary to justify the

cost of and assure the success of a proprietary mutual fund. More importantly this will provide bank customers with more options for investing their savings and thereby allow banks to be more competitive.

This legislation was recommended by the Treasury Department in 1991 as part of its proposals to modernize the banking industry and we have found no opposition to it, either from government officials or industry groups. Last year the provision was scored as revenue neutral, but that number has been re-estimated this year as a $22 million revenue loser because some banks have already converted some trust funds. Those funds could have been exempt employee benefit funds, or funds in which there were no gains, in which case no revenue would have been due to the government. Moreover, it could be argued that conversion to mutual fund form will facilitate more trading on which gains will be recognized and taxed, giving rise to revenue increases for the government. The important point is that in the long run all of the gains on the investments will be fully taxed at the appropriate marginal rates.

Larger institutions which have a broad customer base have already set up proprietary mutual funds and successfully marketed products which have produced strong returns for the customers. For example, at AmSouth, we have an array of four mutual fund choices, which for the past year have been among the leading mutual funds in the country. This has allowed all of our customers to have the choice of benefitting from AmSouth's experience as money manager without having to set up a trust account.

At AmSouth we have had strong customer interest in a mutual fund of tax exempt assets. We need, however, to be able to convert our common trust fund which is invested in tax exempts in order to have enough assets to make a mutual fund succeed. Similarly, smaller banks need this legislation in order to offer products supported with their own investment advice to be available to their non-trust customers. Yet bank customers have continually expressed a desire for bank investment management. Only through collective investment can smaller sums be invested efficiently and economically, and only through collective investment can diversification of small sums be achieved. Bank proprietary mutual funds accomplish that goal.

The benefits to our trust customers who switch to mutual funds are many. Not only will they have the same investment advice and the benefit of strong consumer protection, they will also have the benefit of daily market quotes rather than monthly, and the opportunity to get in and out of the fund daily rather than monthly. Our non-trust customers would have the same advantages.

We should note that this tax proposal does not affect the existing banking and investment laws relating to a bank's role vis-a-vis mutual funds. Banks are permitted to be an investment adviser to a proprietary mutual fund, but they may not be the sponsor, distributor, or underwriter of the fund due to the restrictions of the Glass-Steagall Act. Moreover, the proprietary mutual funds have the benefits of the existing SEC laws which protect the investor.

In addition to the basic legislative proposal permitting conversion of a common trust fund to a single mutual fund, ABA also supports a proposal to permit conversion of the trust fund into more than one mutual fund. This will allow smaller institutions to convert their funds into existing mutual funds managed by others, but still retain the bank-customer relationship. This will allow customers of those banks to have access to a mutual fund investment through their local bank in cases where even the addition of the common trust accounts does

not provide enough critical mass of customers to make a proprietary fund feasible. There are existing mutual fund sponsors which are prepared to take on these customers by combining the accounts from customers of many banks.

While there is a modest revenue loss associated with this proposal, we believe that it is possible under existing law, together with the basic conversion proposal of H.R.13, to accomplish this result on a tax-free basis -- by either first dividing the common trust fund into two trust funds and then convert both, or by converting the trust fund into one mutual fund and then splitting the mutual fund into more than one fund. It would be more efficient to allow the direct conversion to more than one fund, saving lawyers' fees and reducing the risk of any confusion on the part of the bank customer.

FINANCIAL ASSET SECURITIZATION INVESTMENT TRUSTS

The ABA is already on record in support of efforts in the House and Senate Banking Committees to facilitate targeted business loan securitization and experimentation in a secondary market for business loans. The pending bills make reference to the need to clarify the tax treatment of asset backed securities, but of course, actual amendment of the tax law can only occur in the Committee on Ways and Means. The ABA supports the legislation introduced by Reps. Hoagland and Shaw, H.R. 2065, to provide clear rules for asset backed securities, analogous to the REMIC provisions adopted by Congress in 1986.

The legislation provides for the creation of a Financial Asset Securitization Investment Trust (FASIT) which could issue qualified debt instruments backed by bank loans or other debt, without the issuing securities being treated as debt for state law purposes. Today these interests can be sold out of a "Master Trust" based on an opinion of counsel and bearing the cost of external credit enhancement. The FASIT will accomplish the same result without the cost of the legal opinion and the credit enhancement. Another crucial feature of this legislation is that it permits the active management of collateral that is made up of short term assets (as short as 45-days) but have the interests sold to investors via medium term bonds. In contrast, REMICs address splitting up pools of 30-year mortgage loans into shorter term debts.

The ABA supported the REMIC legislation in 1986 as a way to facilitate the growth of the secondary market in mortgage loans, increasing the pool of funds available and thereby reducing the cost of mortgage credit. At that time Congress considered proposals to apply the new rules to all asset backed securities, but it was believed that the secondary market for non-mortgage assets was not sufficiently developed to warrant the same rules. Since that time, the REMIC provisions have proven workable and the market for securities backed by auto loans, credit card receivables and small business loans has grown significantly. Thus, it is now appropriate to expand the REMIC approach to other securities.

We recognize that the lack of standardization of small business loans limits the analogy between FASITs and REMICs, but we believe that the elimination of tax uncertainties and costs associated with asset backed securities will permit careful experimentation in the secondary market for small business loans.

BANK INVESTMENT IN SMALL ISSUER MUNICIPAL BONDS

Over the past decade the active support that commercial banks have given to municipal finance has reduced dramatically, largely because of changes in the tax code. In 1980, banks held

41% of all tax exempt securities, but by the end of 1991 that figure had dropped to 9.6%. This decline continued in 1992 as the 500 largest banks reduced their holdings another $2.5 billion. Tax reform legislation in 1982, 1984 and 1986 each reduced the interest expense banks could claim because of their holdings in municipals, making their after-tax return on these investments less than other investments. The enactment of the alternative minimum tax on corporations further reduced the desirability for banks to hold tax exempts. These provisions affected the cost of and in some cases the availability of municipal credit, especially for small communities, school districts and other issuers of debt obligations which are often unrated and do not have an established market for their debt.

In 1986, Congress retained a "small issuer" exception to the 100% interest expense disallowance rules, in particular because communities which issued less than $10 million in debt each year largely relied on the ability to sell those bonds to local bankers. Communities that qualify as issuers of so-called "bank qualified" bonds enjoy a yield advantage generally in the range of 20 to 30 basis points, but has been as high as 75 basis points. In short, small communities are able to finance their public need more economically because of the bank qualified provision. While the borrowing needs of small communities have risen, the $10 million limit has remained at the level established in 1986. The Anthony Commission Report in October 1989 recommended that it be raised to $25 million, and the Ways and Means Committee took action last year to raise the limit to $20 million, but it was not signed into law.

Mr. Chairman, many bankers feel a strong commitment to support their local government financing needs. Let me illustrate my point by recalling the testimony before this Subcommittee of my fellow banker, Chuck Waterman, Chairman and CEO of South Holland Trust and Savings Bank in Illinois. His local public school district issued a $500,000 anticipation warrant, on which the bank submitted a bid because they felt they had an obligation to support the community. They were the only bidder. In cases, however, where the issuer has needs over the outdated $10 million cap, banks are effectively shut out of the market, and the municipal borrowers have more difficulty borrowing funds.

The evidence is clear that banks have no choice but to limit their purchases of state and local obligations to bank qualified small issue bonds. We urge the Committee to act again to raise the limit to at least $20 million and consider indexing the amount for the future.

BANK HOLDINGS AND SALES OF FORECLOSED PROPERTY

The economic recession that has rolled across major sections of this country for the last few years has left banks with very large holdings of foreclosed property. The burden of holding this property has increased as banks have found it difficult to sell off the properties in the face of depressed real estate markets. Compounding this problem is the fact that there are tax penalties that apply both to bank holdings of foreclosed property and attempts by banks to provide financing to prospective purchasers of property in the banks foreclosed property account.

First, ABA supports Rep. Shaw's proposal to provide that the "at-risk" rules for seller financed property would be satisfied in the case of non-recourse financing by regulated lenders (banks and thrifts) selling foreclosed property. (This proposal was introduced last year as H.R. 3650.) The "at risk" rules under IRC Section 465 are needed in cases where the seller and buyer have an incentive not to limit the financing to the value of the property. In light of the appraisal law requirements with

respect to bank financing, however, there is no risk of abuse. The changes will make financing by regulated lenders be treated in a manner consistent with the 1986 Tax Reform Act exception for third party financing.

Second, while it is not on the Subcommittee's list of issues at the present time, ABA urges that the tax treatment of bank foreclosures conform to the rules for foreclosures by thrift institutions under IRC Section 595. This will allow a bank to claim a loss for the decline in value of the property in the foreclosed asset account, consistent with the bank regulatory agency writedown for book purposes. Not only has this disparity of treatment put an extra cost on banks as compared with their thrift competitors, it serves as a drag on bank capital which restricts bank lending. Under the proposed capital limitations for deferred tax assets of commercial banks, a difference between book writedowns and tax deductions often has the effect of a partial reduction in bank capital. Even if the Subcommittee doesn't include this issue in its current legislative activity, changing the "at risk" rules as proposed by Rep. Shaw will provide some limited relief by allowing banks to finance sales of their holdings of foreclosed real estate, rather than have to continue to hold the property in a declining market.

CONCLUSION

Mr. Chairman, we recognize that the budget reconciliation bill recently passed by the House of Representatives was designed to address broad economic concerns: reducing the budget deficit in a way that spreads the burden fairly and improving the performance of the national economy. We have tried, however, to demonstrate in our testimony today that relatively minor changes in the tax law can significantly improve investment choices for bank customers, enhance the experimentation in a secondary market for small business loans, assist financing for small communities, and reduce the burden of foreclosed property on banks in depressed areas. Each of these changes will contribute in some degree to the health of the national economy. We urge the Congress to address these issues as well as the big picture items in the reconciliation measure.

Mr. HOAGLAND. Now, Mr. Eliasberg, I am told that Congressman Cardin wanted very much to be here to introduce you but was unable to make it due to a conflict and wanted me to make that clear in the record. He very much appreciates your coming today.

STATEMENT OF LOUIS ELIASBERG, JR., MEMBER OF THE BOARD OF DIRECTORS, COMMERCIAL FINANCE ASSOCIATION, NEW YORK, N.Y., AND PRESIDENT, FINANCE COMPANY OF AMERICA, BALTIMORE, MD.

Mr. ELIASBERG. Thank you. I wish to thank the Chairman and my Congressman, Ben Cardin, for the opportunity to present my views and those of the trade association, the Commercial Finance Association, on a vitally important matter to small commercial finance companies.

Commercial Finance Association is an organization of commercial finance companies and commercial banks that provide small- and medium-sized businesses secured monitored loans. I am president of one such company, the Finance Co. of America, a 76-year-old Baltimore-based commercial finance company.

I am here to comment on the tax proposal you are considering today that, if enacted, would restore fairness between two competitive suppliers of credit for small businesses in this country—small commercial finance companies and small banks. The passage of this proposal would allow the budgeting of loan losses, which are inevitable risks of our business.

This proposal would amend section 585 of the code and restore the loan loss reserve method of accounting for small commercial finance companies.

Without credit and continuous supply of funds, commercial finance companies are not able to assist in providing the working capital needed for small businesses, which are such an important source of employment, especially at a time like this when we need all the assistance we can get for the economy. It is unnecessary to have traditional sources of funding, such as small commercial finance companies, precluded from making loans because of an accounting change in the industry.

I wish to call your attention to the fact that the Senate Finance Committee reported on the Tax Reform Act of 1986 that:

> * * * finance companies are important competitors in financial institutions * * * in order not to provide unfair competitive advantage to financial institutions, the committee believes that the use of the reserve method of accounting for bad debts also should be continued for these finance companies as well.

Thank you, members of the committee, for this opportunity to speak before the panel.

Mr. HOAGLAND. Thank you, Mr. Eliasberg.

[The prepared statement and attachments follow:]

STATEMENT OF LOUIS ELIASBERG, JR.,
BOARD OF DIRECTORS OF THE COMMERCIAL FINANCE ASSOCIATION,
NEW YORK, NEW YORK

I wish to thank Chairman Rangel and my Congressman, Ben Cardin, for this opportunity to present my views and those of my trade association, the Commercial Finance Association, on a matter of vital importance to small commercial finance companies. The Commercial Finance Association is the national organization of commercial finance companies and commercial banks that provide financing to small- and medium-sized businesses through secured monitored loans. I am President of one such finance company, The Finance Company of America, a 76 year old Baltimore based commercial finance company; serving the eastern United States, specializing in financing accounts receivables for manufacturers, jobbers and distributors, rediscounting loans for financial institutions, industrial time sales and leasing since 1917.

I am here to comment upon a tax proposal you are considering today that, if enacted, would restore fairness among two competitive suppliers of credit to the small businesses of this nation -- small commercial finance companies and small banks -- and allow the proper recognition of a real business expense of the small finance companies, the budgeting of losses on loans which is an inevitable risk of our business. This proposal would amend Section 585 of the Code and restore the loan loss reserve method of accounting for small commercial finance companies. The reserve method of accounting was repealed by the Tax Reform Act of 1986 for all taxpayers except small banks, i.e., those with assets of $500 million or less. The Tax Act has allowed small banks to take advantage of the provision while placing small finance companies at a competitive disadvantage.

Congressman Cardin introduced in both the 101st and the 102nd Congresses, legislation to restore the loan loss reserve method of accounting for small finance companies. Since the provision's repeal, small finance companies have been unable to use the loan loss reserve method of accounting which would allow them to properly allocate the projected loan losses based on their company's experience as a normal operating expense instead of incurring the expense in a single year when it could materially effect the profits of a company if not totally eliminate the profits. Many finance companies have experienced financial difficulties during the recent recession and concomitant credit crunch, as capital from our credit suppliers and banks became difficult to obtain. Allowing commercial finance companies the use of the reserve method would once again allow them to demonstrate to their credit suppliers their knowledge of their business by providing for those inevitable loan losses as a part of the expense of business, like postage, rent and legal fees. Allowing the expense of a loan loss as a tax deductible expense only when the loan is finally identified causes extreme fluctuations in commercial finance company earnings which is an important consideration when credit suppliers are considering making a loan to a commercial finance.

Without a continuous supply of funds the commercial finance companies are precluded from assisting companies in need of working capital especially at times like these when small businesses, an important source of employment, are frequently not eligible for bank loans under today's new restrictions on the type of loans banks can consider. At a time like this when the country is looking for growth and stimulus from the private sector, the unnecessary loss of a traditional source of funds

because of an accounting change which the industry and the accounting profession have identified as a mistake, is an unnecessary handicap to the economy. Other major advantages that stem from the use of the reserve method include:

- this revision is not being sought to reduce taxes but, to allow for the prudent and wise budgeting of the risk of financing ventures;

- the bad debt reserve would be limited to a sixteen year or a six year moving average thus insuring that the company' s own bad debt experience would determine the tax paid expense allowed;

- the bad debt reserve would no longer be a set industry percentage which might permit excess accumulation of reserve for some companies or under reserving for other companies;

- the year of the deduction is more in line with the financial and accounting reality because the reserve method recognizes that all debts/receivables will not be collectible and provides for an appropriate reduction in net income in the year the net income is taken into account and taxed;

- larger additions to the reserve are appropriately permissible in years of high sales volume since the risk is greater as the number and size of loans increase;

- the earnings for small finance companies are small and the credit exposure is disproportionately large therefore, on occasions, the bad debts could completely wipe-out or materially reduce the earnings of the company in any given year;

- the reserve method offers relative simplicity for the taxpayer with a large number of accounts because it eliminates identifying which specific debt is worthless;

- the taxpayer is relieved of the heavy burden of establishing partial or complete worthlessness and the exact tax year of such worthlessness with respect to each specific charge-off.

- taxes and Generally Accepted Accounting Principles (GAAP) would be the same. (Since GAAP does not allow commercial finance companies to overstate income by disregarding the exposure to potential losses on loans, the tax law should not require them to overstate income for tax purposes.)

On the national level, eight-five commercial finance companies, including the company I represent, are members of the Commercial Finance Association. Each year, our companies collectively provide millions of dollars to small businesses throughout the country. These small businesses - manufacturers, wholesalers, distributors, processors - are essential to the strength of our national economy. By financing these companies,

tens of thousands of jobs are created directly, with many more resulting from the multiplier effect. Because many of these small businesses, for various reasons, are declined financing by banks, commercial finance companies have traditionally provided them with alternate means of obtaining capital.

On a personal level, the company I represent, The Finance Company of America, finances small businesses in almost every industry in the Middle Atlantic states except for rolling stock and construction equipment for which there are financing specialists. Loans range from $100,000 to $1,000,000. Over our 76 year history, we have financed almost 2,000 ventures in relationships that were for 6 months or over 30 years with loans totaling almost $4.5 billion dollars.

The customers that we served have as few as 6 employees with sales of less than $250,000 to several hundred employees operating in a half a dozen states with annual sales volumes in excess of $10 million dollars.

We currently have more loan requests for good business than we have available funds to invest and yet we hear stories of banks whose loan portfolios are down because of lack of demand. A few years ago, our annual loan volume was in excess of $130 million dollars and today, because of restricted available credit, our loan volume is only a fraction of what it was less than 5 years ago.

The attached chart clearly demonstrates that our taxes would be the same over 16 years if we used the 16 year moving average as an expense instead of our bad debt charge offs for the year to reduced our income. The amendment to the Internal Revenue Code restoring the deduction for bad debt reserves would eliminate the peaks and valleys and level out the charges for bad debts, thus permitting the continuity of earnings so important when seeking credit approval.

We are, therefore, asking this Committee to consider amending the Internal Revenue Code to restore the deduction for bad debt reserves to any eligible commercial finance company whose principal business is providing commercial financing through commercial loans, the purchase of accounts receivables or leveraged equipment financing or leases, and whose assets are less than $500 million. We ask that you consider what was stated in the Senate Finance Committee Report on the Tax Reform Act of 1986,

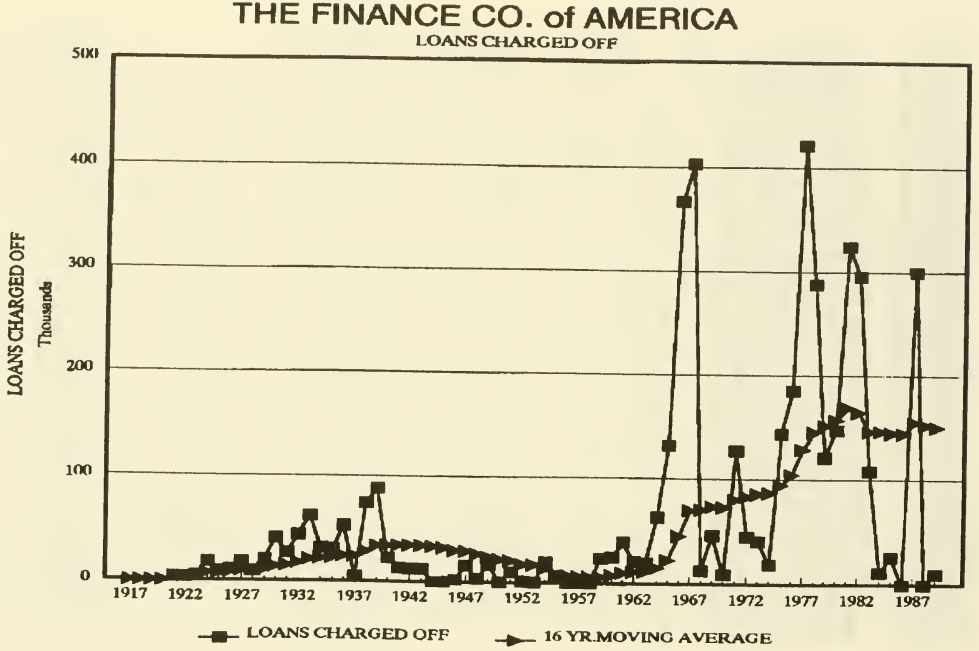
> "Financial companies are important competitors of financial institutions.....In order not to provide an unfair competitive advantage to financial institutions, the Committee believes that the use of the reserve method of accounting for bad debts also should be continued for these finance companies as well." Senate Report No. 313, 99th Congress, 2nd Session (1986).

Restoring this provision would, as previously and simply stated, allow small commercial finance companies to properly allocate income and expenses to periods in which they occurred and retain more of their cash each year. It also would have an economic multiplier effect on the nation's economy. The extra

cash would improve the finance company's capital structure, stabilize earnings, and allow the company to borrow more to fund its own lending activities. Small businesses would benefit from the increased availability of loans and the finance companies would also benefit from the increase in the business they could do with the additional funds they could lend.

Mr. Chairman, in a time when it is crucial to make every effort to stimulate small business, I join with other small commercial finance companies in offering a way by which many of these worthy small companies, who may otherwise not be financed by traditional bank loans, may obtain working capital and prosper into vital, productive businesses. We urge the adoption of the amendment to Section 585 so that small commercial finance companies may be permitted to use the loan loss reserve method of accounting, permitting continuity of earnings which are such an important factor in determining the credit worthiness of a borrower, and a fairness with small banks.

I thank the members of this Subcommittee for the opportunity to speak before this panel.


THE FINANCE CO. of AMERICA
LOANS CHARGED OFF
LOANS CHARGED OFF
Thousands
500
400
300
200
100
0
1917
1922
1927
1932
1937
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1972
1977
1982
1987
LOANS CHARGED OFF
16 YR.MOVING AVERAGE

COMMERCIAL FINANCE ASSOCIATION

Questions and Answers on a Bill to Restore
Bad Debt Reserves for Small Commercial Finance Companies

How does the direct charge off method of accounting for bad debts work?

A. Under the direct charge off method, bad debts are not allowed as a deduction from taxable income until they become worthless. While legal action is not required to establish worthlessness, facts and circumstances must support the charge off of a debt as worthless in any given year.

How does the reserve method of accounting for bad debts work?

A. The reserve method, as used by small banks, is based on the loan loss experience of the bank over the past six years. The computation of the reserve is made by taking the ratio of the total net charge offs over the past six years to the sum of total loans outstanding at year end over the past six years. This ratio is then applied to the total loan balance at the end of the current year to determine the necessary ending balance in the reserve. The addition to the reserve (i.e., the deduction) is the amount needed to bring the reserve to the year end balance determined above after subtracting the current year charge offs from the beginning reserve balance.

Is there a different standard for determining charge offs when using the reserve method?

A. No, the same standards for establishing worthlessness exist under the reserve method as under the direct charge off method. However, the year in which the charge off occurs has less direct impact on the amount of the deduction under the reserve method because of the averaging which takes place under that method.

How are bad debt recoveries treated under each method?

A. Under the direct charge off method, recoveries of bad debts are included in income in the year of recovery.

Under the reserve method, recoveries of bad debts are netted against charge offs occurring in the same year to determine net charge offs.

Mr. HOAGLAND. Mr. Manning.

STATEMENT OF DAVID E. MANNING, DIRECTOR, GOVERNMENTAL RELATIONS, COMMUNITY BANKERS ASSOCIATION OF ILLINOIS

Mr. MANNING. Mr. Chairman, thank you for the opportunity to testify.

I am the director of governmental relations for the Community Bankers Association of Illinois. My association represents 510 commercial banks throughout the State of Illinois. The average member bank in our association has assets of approximately $50 million. Three hundred and fifty member banks in our association in Illinois are located in towns of less than 5,000. They are sometimes referred to as mom and pop banks.

I am testifying today in support of the proposal to permit a bank common trust fund to transfer its assets to one or more mutual funds without current tax to the common trust fund participants. This proposal expands on a provision of H.R. 13, introduced earlier this year by Chairman Rostenkowski, to permit the tax-free reconversion of a bank common trust fund to a single mutual fund. The clarification is supported by both the banking industry and the mutual fund industry, and there is no known formal opposition.

In my home State of Illinois alone, there are approximately 175 bank common trust funds with combined assets of more than $14 billion. However, most of these funds are relatively small and reside with small trust departments such as those at community banks.

Permitting a common trust fund to transfer its assets to more than one mutual fund pursuant to a single plan would open up a range of new investment opportunities to the customers of these community banks while permitting these institutions to compete on a level playing field with larger institutions.

A bank common trust fund essentially provides a vehicle for the combined investment of accounts held by a bank on behalf of its customers. The collective investment of these fiduciary accounts allows each account to achieve investment diversification and creates efficiency of administration that would not be available if each account were handled separately.

There are several reasons why a bank would want to divide a common trust fund into mutual funds for its customers. In many respects, mutual funds provide a much more flexible and attractive investment vehicle for investors than common trust funds. For trust department customers, the conversion of assets to mutual funds provides the opportunity for greater economies of scale, diversification and liquidity. Such mutual funds will have a diversified cash flow from all customers of the bank as well as, potentially, from outside the bank. In contrast, a bank common trust fund relies solely on the cash flow from fiduciary accounts of the bank.

However, because a mutual fund is treated as a corporation while a common trust fund is not, a common trust fund cannot be merged into or acquired by a mutual fund in a tax-free transaction under the corporate reorganization provisions of the code. The conversion of a common trust fund into a mutual fund is presently

treated as a taxable transaction for the participants in the common trust fund.

H.R. 13 would permit banks and their customers to take advantage of the benefits of converting common trust funds into mutual funds by deferring any such tax. Our proposal would simply clarify this change to ensure that a common trust fund could divide its assets into more than one mutual fund. We believe this makes sense from a policy perspective, and it creates numerous advantages for both participants in those funds and the institutions that manage the funds.

Thousands of individuals depend upon their local bank to act as trustee, guardian, executor, or administrator on their behalf. These individuals should not be forced to move away from their local bank in order to take advantage of new investment opportunities available only to larger institutions.

The proposed change to section 623 of H.R. 13 will allow banks of all sizes to enjoy the benefits of mutual fund conversions on behalf of their trust clients and allow hundreds of community banks to retain their best customers.

Again, thank you, Mr. Chairman, for the opportunity to testify today.

Mr. HOAGLAND. Thank you, Mr. Manning.

[The prepared statement follows:]

STATEMENT OF DAVID MANNING, DIRECTOR OF GOVERNMENTAL RELATIONS, COMMUNITY BANKERS ASSOCIATION OF ILLINOIS

Introduction

My name is David Manning and I am the Director of Governmental Relations for the Community Bankers Association of Illinois. I am testifying before you today in support of the proposal to permit a bank common trust fund to transfer its assets to one or more mutual funds without current tax to the common trust fund participants. This proposal expands on section 623 of H.R. 13, the Tax Simplification Act of 1993, introduced earlier this year by Ways and Means Committee Chairman Dan Rostenkowski (D-IL), to permit the tax-free conversion of a bank common trust fund to a single mutual fund.

The Community Bankers Association of Illinois represents 510 commercial banks throughout the state. It is the only trade association exclusively representing Illinois community banks. The average member of our association is a small banking institution, with approximately $50 million in assets.

In my state of Illinois alone, there are approximately 175 bank common trust funds with combined assets of more than $14 billion. However, most of these trust funds are relatively small and reside with small trust departments, such as those at community banks.

Background

A bank common trust fund essentially provides a vehicle for the combined investment of accounts held by a bank in its capacity as a trustee, executor, administrator, guardian, or custodian on behalf of its customers. These funds are comprehensively regulated by the Comptroller of the Currency.

Nationwide, bank collective and common trust fund assets totaled $520 billion as of December 31, 1991, according to data compiled by the Federal Financial Institutions Examination Council. Of this amount, $125 billion was in personal trust funds, subject to current taxation. The remaining assets were in employee benefit, Keogh, or charitable trusts. The collective investment of these fiduciary accounts allows each account to achieve investment diversification and creates efficiency of administration that would not be available if each account were handled separately. Bank common trust fund assets are invested in diversified portfolios with a wide variety of investment objectives, ranging from short-term investment funds equivalent to money market funds to a variety of debt and equity funds.

Tax aspects of common trust funds

Under section 584 of the Internal Revenue Code (the "Code"), a common trust fund is treated as a conduit, and its income is passed through to the participants in the fund on a proportional basis, whether or not such income is distributed or distributable. No gain or loss is realized by the fund upon admission or withdrawal of a participant. Participants generally treat their admission to the fund as the purchase of such interest. Withdrawals from the fund generally are treated as the sale of such interest by the participant.

The taxation of common trust funds is, in many respects, similar to that of regulated investment companies (RICs), commonly known as mutual funds. Both types of entities are treated as conduits for tax purposes, passing taxable income through to their participants.

However, because a mutual fund is treated as a corporation, while a common trust fund is not, a common trust fund can not be merged into or acquired by a mutual fund in a tax-free transaction under the corporate reorganization provisions of the Code. The conversion of a common trust fund into a mutual fund, or the acquisition of the assets of a common trust fund by a mutual fund, is presently treated as a taxable transaction for the participants in the common trust fund.

H.R. 13 would permit banks and their customers to take advantage of the benefits of converting bank common trust funds into mutual funds. Conversion of common trust funds to mutual funds with similar investment objectives do not occur currently because state laws may treat the triggering of an income tax on trust fund participants as a breach of the banks' fiduciary obligations if the conversion is performed primarily to change the structure of the investment vehicle.

Why convert common trust funds into mutual funds?

Banks are interested in converting common trust funds into mutual funds because of the numerous advantages created for both participants in those funds and the institutions that manage the funds.

It is important to understand that mutual funds offered by banks fall into two categories: proprietary, "private-label" mutual funds, and so-called non-proprietary mutual funds.

Proprietary, or private-label funds, are those established and managed by banks themselves. From an industry perspective, the costs of administering such funds necessitates a minimum level of fund assets of between $50 million and $100 million for the funds to be self-sustaining. Such funds generally are established for sale exclusively or primarily to bank customers. For these institutions, converting their bank common trust funds into private label mutual funds will mean the bank may perform various services for the funds, including serving as investment advisor, shareholder servicing agent, and custodian. Banks with the expertise and existing assets to operate such funds generally will find it beneficial to design a new private label fund to convert one common trust fund to one mutual fund.

For smaller, community banks, developing private label mutual funds is not an option since these smaller institutions cannot amass the critical pool of money to justify a fully diversified and self-sustaining mutual fund. Instead, these banks will look to non-proprietary, existing mutual fund products managed and administered by third parties for conversion of their bank common trust funds.

In Illinois, for example, only 31 of the 175 bank common trust funds have assets of $100 million or more, and all of those reside in the five largest Illinois banks.

In many respects, mutual funds provide a much more flexible and attractive investment vehicle for investors than common trust funds. For trust department customers, the conversion of assets to new mutual funds provides the opportunity for greater economies of scale, diversification, and liquidity. Such mutual funds will have a diversified cash flow from all customers of the bank, as well as potentially from outside the bank. In contrast, a bank common trust fund relies solely on the cash flow from fiduciary accounts of the bank.

The ability to convert a common trust fund to one or more mutual funds will facilitate the offering of new investment products, especially by medium-sized and small banks. Increasingly sophisticated securities markets require sufficient resources and expertise not generally available to smaller entities. By merging common trust funds into larger mutual funds, smaller banks achieve not only economies of scale, but can benefit from the mutual fund market without the prohibitively high start-up costs of entering the market themselves.

Conversion provisions of the proposal

Under H.R. 13, the conversion of a common trust fund to a mutual fund, or RIC, would be treated as a transfer of the common trust fund assets directly to a RIC in exchange for RIC shares, followed by a distribution of those shares to participants in exchange for their common trust fund shares. Common trust fund participants would avoid taxable gain recognition on what is viewed as an otherwise taxable transaction if:

1) The common trust fund transfers substantially all of its assets to one RIC in exchange solely for RIC shares,

2) Those shares are distributed to participants in exchange solely for their interests in the common trust fund,

3) The RIC does not assume liabilities associated with the common trust fund's assets in excess of the common trust fund's aggregate adjusted basis of the transferred assets, and

4) The common trust fund's assets are diversified (within the meaning of section 368(a)(2)(F)(ii) of the Code).

If these requirements are satisfied, the RIC would receive a carryover basis in the common trust fund assets transferred to it, and each participant would receive a substituted basis in the RIC shares.

Our proposal would clarify this language to allow a common trust fund to transfer, on a tax-free basis, substantially all of its assets to one or more RICs pursuant to a single plan. To do so, however, each participant's pro-rata interest in each of the RICs must be substantially the same as was the participant's pro-rata interest in the transferring common trust fund. In addition, each participant's basis in the stock of each RIC must be determined under the rules applicable to the division of a common trust fund.

Under current law, a common trust fund may divide, on a tax-free basis, into two or more common trust funds if certain rules are followed. The effect of these rules is to ensure that disposition of an asset by a resulting common trust fund would produce tax consequences to each participant virtually identical to those that would have occurred absent the division.

Need to permit tax-free conversions into multiple mutual funds

The proposal to permit tax-free conversion of a single bank common trust fund to one or more mutual funds is critical if smaller institutions are to allow their customers to benefit from such conversions. As discussed above, smaller, community banks have found it prohibitively expensive to establish proprietary, private-label mutual funds for their customers. Yet, to take advantage of the proposal included in H.R. 13 to permit the tax-free conversion of a bank common trust fund into a single mutual fund, a bank may be required to design and establish specific mutual funds in order to provide the best match with the investment objectives of each common trust fund.

The need to use more than one mutual fund will arise when an institution too small to manage private-label funds desires to convert its common trust funds to mutual funds, or when any bank desires to convert a common trust fund that is too small to become the nucleus of a single new mutual fund. Because of the bank common trust funds' unique investment objectives, they may not fit into one existing mutual fund. Normally, bank common trust funds have broader investment objectives than are typical for mutual funds. For example, a bank equity fund could potentially hold a combination of blue chip and growth stocks. A smaller bank may not be able to find a single mutual fund that would best match the investment objective of this common trust fund, and thus may require two separate mutual funds in order to convert 100 percent of the assets of the common trust fund.

In addition, a common trust fund may have invested in securities with a wide range in quality, combining, for example, both rated, investment-grade securities and unrated or below-investment grade securities. A mutual fund with the same basic investment objective, but with investment policies geared towards rated, investment-grade securities would only be able to accept some, but not all, of the common trust fund's portfolio of investments.

Permitting conversions only from one common trust fund to one mutual fund would thus penalize participants in smaller bank common trust funds and provide larger banks that can afford to design private label funds with a competitive advantage.

Conclusion

Permitting a common trust fund to transfer its assets to more than one mutual fund, pursuant to a single plan, is only a slight technical clarification to the current legislative proposal offered by Chairman Rostenkowski in H.R. 13. This clarification has the support of both the mutual fund industry and the banking industry precisely because it will substantially enhance the usefulness of the original proposal.

Most importantly, the proposal would provide fair treatment to banks with relatively small trust departments, permitting their customers to take advantage of additional investment opportunities while keeping the customers' investment assets within the same community bank.

Mr. HOAGLAND. Mr. Susswein.

STATEMENT OF DONALD B. SUSSWEIN, COUNSEL, COALITION FOR ASSET BACKED SECURITIES

Mr. SUSSWEIN. Thank you, Mr. Chairman, for the opportunity to testify for the Coalition of Asset Backed Securities in support of your bill, H.R. 2065, the FASIT legislation, which you introduced along with Congressman Clay Shaw.

The coalition is a diverse group of banks and other institutions that make loans, and companies that issue and underwrite securities that are backed by loans.

Accompanying me today are representatives of two of our members, Hall Doersam from Household International of Chicago, Ill., and Mike Coco from the Colonial National Bank located in Horsham, Pa.

The individual companies in the coalition, I am happy to say, are joined in their support of FASIT by the American Bankers' Association, as Ms. Kern indicated, Public Securities Association, the Securities Industry Association, and other financial trade associations.

I think we all support this bill because it would help increase the supply of credit for lending, increase the safety and soundness of the financial system and, actually, also reduce the dependency of the lending business on Federal guarantees, such as guarantees of the FDIC. Basically, the bill would do this following on the path laid down by the Congress in the very successful REMIC legislation by making it easier to securitize loans.

REMIC, of course, which was passed in 1986, was limited to mortgage loans and designed specifically for mortgage loans. FASIT would extend some of those concepts to other types of loans.

I think I can best illustrate the major points I would like to make today graphically.

First of all, up on easel, you will see a chart which is formally titled "Securitization Increases Capital Availability." The chart could just as easily be called "the credit crunch that never happened." It illustrates that after the REMIC legislation was passed in 1986 we have had a continuing availability of mortgage money. This is probably the one area where we haven't had a credit crunch in this country in the last 10 years or so. This is because, as you can see from the graphic illustration, securitization has filled the gap where traditional lenders have been unable to meet the demand.

The red on the bottom shows the traditional nonsecuritized mortgages. The green shows the increasing role that securitized mortgages are playing.

The second point I would like to make has to do with what FASIT is going to do. It is going to do two things: First, it will make the law a little bit clearer and more accessible to more players. Right now, there is a highly complex set of tax rules which are primarily available to tax lawyers through the case law.

FASIT is going to put the law into the statute. The law will be more understandable and available to more people as a result.

Second, if I can turn to my other chart, FASIT is going to decrease reliance on credit enhancers. Today, since we don't rely on Federal guarantees, we have to turn to credit enhancement, which

typically comes in the form of a guarantee issued by a top-rated commercial bank. Instead of getting guarantees from an increasingly short supply of AAA-rated commercial banks, which are increasingly primarily foreign, as this next chart shows, FASIT will make it easier to access the capital markets generally for this function.

There is a problem of ensuring a continued supply of capital, and I think if you just look at the chart, you will see how serious a dependency we now have on foreign AAA-rated commercial banks. And we hope FASIT will help reduce that.

Thank you very much.

Mr. HOAGLAND. Thank you, Mr. Susswein.

[The prepared statement follows:]

The Coalition for Asset Backed Securities
Testimony of Donald B. Susswein
Counsel, The Coalition for Asset Backed Securities
on H.R. 2065
Before the Subcommittee on Select Revenue Measures
Committee on Ways and Means
U.S. House of Representatives
June 17, 1993

Introduction

Thank you for the opportunity to testify today. My name is Donald B. Susswein. I am a tax partner with the law firm of Thacher Proffitt & Wood. I am pleased to be testifying for the Coalition for Asset Backed Securities in support of H.R. 2065 -- the "FASIT" legislation introduced by Congressman Peter Hoagland (D. NE) and Congressman Clay Shaw (R. FL).

The Coalition For Asset Backed Securities is a diverse group of banks and other institutions that make loans, and companies that issue and underwrite securities backed by loans -- often referred to as asset backed securities. In addition to our individual members,[1] I am pleased that the Coalition is joined in its support of the FASIT legislation by a broad spectrum of financial services trade associations including the American Bankers' Association, the Savings and Community Bankers of America, the Public Securities Association, the Securities Industry Association, and the Equipment Leasing Association of America. I am accompanied today by representatives of two of our members, Mr. Hal Doersam from Household International and Mr. Mike Coco from Colonial National Bank.

We support FASIT because it would help increase the supply of credit for lending, increase the safety and soundness of the nation's financial system, and reduce the private sector's reliance on explicit or implicit guarantees of the Federal Deposit Insurance Corporation ("FDIC") or other Federal agencies. The bill would accomplish these goals by making it easier to turn pools of relatively illiquid loans on the books of banks and other lenders into highly liquid, marketable securities that rely for their creditworthiness solely on the underlying loans or on guarantees or other forms of credit enhancement provided by the private sector.

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[1]The Coalition for Asset Backed Securities is comprised of the following companies and associations:

Advanta Corp./Colonial National Bank
American Bankers' Association
Chemical Bank
Citicorp/Citibank
Equipment Leasing Association of America
First Boston Corporation
Goldman Sachs & Company
Household International
Investment Program Association
Lehman Brothers
Merrill Lynch & Co., Inc.
Morgan Stanley
Public Securities Association
Salomon Brothers, Inc.
Savings & Community Bankers of America
Securities Industry Association
Union Bank of Switzerland

The Importance Of Securitization

The FASIT legislation would build on Congress' highly successful experience with similar tax legislation that promoted the securitization of mortgage loans. In part as a result of the REMIC provisions of the 1986 Tax Act, the country has experienced an era of unprecedented credit availability, liquidity, and diversification of financial risk in the mortgage markets over the last six years. This has occurred despite the fact that many other sectors of the credit and financial markets have experienced their share of economic difficulties during the same period.

To illustrate this point, we have prepared a chart showing the amounts and sources of mortgage money over the last decade. The chart is reproduced at the end of my testimony. As you can see, the total supply of mortgage money has been steadily increasing, despite the fact that the portion -- shown in red -- provided without reliance on securitization has been declining both as a percentage and, most recently, as an absolute amount. This chart bears the title "Securitization Increases Credit Availability," but it could be called "The Credit Crunch That Never Happened." It illustrates the fact that securitization has helped keep the supply of mortgage money in line with the demand for mortgage credit, even as many traditional sources have been forced by economic circumstances to curtail their participation in this market.

Securitization of loan pools is attractive from an economic and business perspective because of several advantages it offers to lenders and borrowers over other forms of financing.

First, because securitization increases the amount of information investors have about the risks involved in holding a pool of loans, investors become more comfortable with those risks and more willing to invest in the pool.

Second, securitization makes it possible to segment the different categories or types of economic risk associated with a pool of loans. As a result, it is often possible to make a better match between various risks and the investors that are most knowledgeable about -- and comfortable with -- undertaking those risks. For example, some investors may be more comfortable evaluating and assuming the risk of borrower default, while others may be more comfortable evaluating and assuming the risk that market interest rates will rise or fall.

Third, by converting a pool of loans into a marketable security -- even if that security is retained by the original lender -- the loans become more liquid, and therefore more valuable. Liquidity -- which can be defined as the ability to readily sell or liquidate a loan or security at a price closely reflecting its inherent value -- also makes for safer and sounder financial markets.

Fourth, by increasing information, risk segmentation, and liquidity -- the first three items already mentioned -- securitization makes it easier for lenders and investors to achieve appropriate diversification of their portfolios. Diversification can help prevent a localized economic problem -- such as a sudden change in the price of energy, real estate, or other commodities crucial to the local economy -- from dragging down all of an area's local financial institutions and potentially causing serious regional or national financial problems. Lenders and bank regulators do their best to avoid taking undue risks -- but there are always unpredictable or unanticipated factors. Diversification helps manage the risk of the unknown.

FASIT Is The Tax Counterpart To Recent SEC Actions
Rationalizing The Legal Rules Applicable To Asset Securitization

Because of these economic and business advantages, securitization is becoming one of the most economically efficient ways to obtain and provide funds for lending activities. This trend was furthered by actions taken last year by the

Securities Exchange Commission to rationalize the securities laws governing asset backed securities.

After decades of issuing rulings allowing particular types of assets -- such as mortgage loans or consumer loans -- to be securitized with the blessings of the SEC, the Commission decided to adopt a generic approach to the treatment of what they referred to as "structured financings." Under this new approach, any structured financing could proceed as long as certain structural safeguards and investor protections were satisfied, without regard to the type of loan or asset involved. The SEC's explanation of its action is worth noting, because it echoes the thinking underlying the FASIT legislation introduced by Congressman Hoagland and Congressman Shaw.

In describing the law applicable before 1992, the Commission explained, the securities laws treated --

> "similar types of structured financings very differently, depending solely on the asset securitized."

As a result, they explained --

> "Some sectors of the economy, including small business, generally are unable to use structured financings as sources of capital, and many United States investors are denied the opportunity to purchase sound capital market instruments."[2]

In many ways the FASIT legislation is the tax code counterpart to the SEC's actions to promote asset securitization. Like the SEC's actions, FASIT would eliminate much of the disparity in tax treatment between certain selected classes or types of assets, which are currently allowed to obtain direct access to the capital markets through statutorily sanctioned vehicles, and other types or classes of assets which do not yet enjoy that treatment under the tax law. FASIT accomplishes this with a generic rule, like the SEC's approach, which allows all types of loans to be securitized as long as appropriate structural limitations and safeguards are in place. In the case of FASIT, however, the structural limitations and safeguards are designed to protect the tax policy concerns of the Treasury Department.

Tax Issues In Securitization

To understand exactly what FASIT does, and why it is beneficial, it is necessary to understand a little about the way asset securitizations are structured under current tax law.

Securitization of loans depends on the ability to pass through to investors all or a significant portion of the interest income that is earned on a pool of loans without the imposition of an intervening corporate tax. As a tax matter, this is essentially what occurs when a bank makes loans with funds that it has obtained from deposits or other borrowings. Corporate taxes are paid by the bank only on the portion of the interest income received that is not paid out as interest to its depositors or other creditors. The portion that is paid to depositors is not subjected to an entity level tax, but is simply included directly in the depositor's required tax computation.

Traditional securitizations typically involve the use of a special purpose financing vehicle as the holder of the loans, and issue debt securities instead of raising funds from bank deposits, but the tax principle is the same. That is, assuming that the financing vehicle is a corporation, corporate taxes are paid only on the portion of

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[2]Securities and Exchange Commission Release No. IC-19105/November 19, 1992, Investment Company Act of 1940.

the interest income received that is not paid out to the holders of debt instruments issued by the entity. As a result, a key tax issue is determining how best to structure the transaction so that the securities qualify as debt, rather than as an ownership interest in the special purpose entity.

With REMICs, or similar entities structured under the tax law as fixed investment trusts or partnerships, the task of securitizing loans becomes much easier because 100 percent of the income paid out to investors is passed through without the imposition of an intervening corporate tax. This complete pass-through treatment is available regardless of whether the securities are classified as debt or as equity (i.e., ownership interests). Thus, the problem of determining how best to structure a security so that it satisfies the business objectives of the parties and still qualifies as debt for tax purposes is eliminated. As long as the broad structural requirements of these statutory vehicles are satisfied, the issuer is free to structure the security so that it optimally satisfies the parties' economic and business needs.

Once pass-through treatment is assured, the technical rules governing REMICs, grantor trusts, and partnerships concern themselves with ensuring that there is an appropriate allocation of income among different classes of owners. Rules of this sort do not pose any problems for loan securitization since loan securitization is motivated by economics, not by tax considerations. Thus, once pass-through treatment is assured, issuers' tax objectives become the same objectives generally viewed as the goals of "good tax policy"; that is, to ensure that each investor's taxable income reflects its true economic income -- no more and no less.

Key Tax Provisions Of FASIT

Like the REMIC provisions before it, the FASIT legislation will help make loan securitization easier by creating a new pass-through structure specifically designed for loan securitization. Unlike REMICs, FASITs will be available for all types of loans or other instruments treated as debt for Federal income tax purposes.

In general, FASITs must be beneficially owned by U.S. banks or other U.S. corporations. Although the FASIT itself will not be subject to any tax, its net income will be included in the U.S. income tax return of its owner or owners, and thus will, in virtually all cases, be subject to corporate income tax.[3]

Loans will be transferred or sold to the FASIT so that it can issue securities backed by the loans it has acquired. As with REMICs, FASITs will be permitted to issue securities that qualify as debt of the FASIT for Federal income tax purposes even though they are issued in non-debt form (i.e., as certificates of ownership of the underlying assets) for state law purposes.

Issuing securities in the form of ownership certificates is necessary in order for regulatory agencies and financial accounting statements to properly recognize the fact that the assets of the FASIT are the sole source of payments on the securities, and the fact that any risk of loss on the assets that is borne by the owners of the FASIT has been limited to a reasonably estimable amount. At the same time, treating such certificates as debt of the FASIT for tax purposes means that the portion of FASIT income passed through to the holders of the certificates is not included in the FASIT income that is passed through to the corporate owners of the FASIT.

A disparity of this sort between state law form and tax law characterization is consistent with the well established principle that the tax treatment of a transaction is governed by its substance rather than its form. The FASIT legislation makes the rules for qualifying securities as debt, based upon their

[3]An exception, intended to facilitate small business loan securitizations, will allow businesses operated as partnerships or S corporations to retain ownership of FASITs used to securitize loans to their customers, such as trade receivables.

economic substance, clearer and more straightforward. In so doing, FASIT makes the tax rules governing the most advanced type of securitization structures more accessible to a wider variety of issuers and their tax counsel. Based on the experience with REMIC, this should make for more competition among a broader universe of issuers, underwriters, and their tax advisors, and a more liquid and more efficient marketplace.

In addition to making the applicable legal rules and standards more accessible, FASIT will also ease some of the common law rules that are generally perceived as governing this type of securitization.

Under current case law, it is generally perceived that issuers of securities purporting to qualify as debt for tax purposes on the basis of their economic substance -- notwithstanding their non-debt form -- should be able to point to "strong proof" that the securities have the economic characteristics of debt. Tax advisors have generally adopted a self-imposed guideline that insists on a high investment grade rating (i.e., "A" or better) to assure themselves that the "strong proof" standard can clearly be satisfied.

Under the FASIT legislation, debt securities can be issued as long as they do not have a yield that is more than 5 percentage points higher than the yield on Treasury obligations with a comparable maturity. As compared to the conservative practice of tax counsel to the leading issuers, this will permit more subordinated debt securities to be issued. It should be pointed out, however, that even debt securities at the top end of that yield limitation are still fundamentally debt-like. The 5 percentage point standard is actually borrowed from current tax law rules that govern when certain high-yield discount bonds will be subject to special rules deferring accrued interest deductions.[4] These rules effectively assume that obligations yielding 5 points more than Treasury bonds could and do qualify as debt. Thus, the FASIT legislation will not be authorizing the issuance of debt securities that are fundamentally different from debt securities that are currently outstanding in the markets.

The yield limitation, which limits how much income can be passed through to the holders of FASIT debt instruments, is important because all remaining income -- the income associated with the true equity-like risk of investing in a pool of loans -- will be taxable to the U.S. banks or other U.S. corporations that retain or acquire the ownership interests of the FASIT.

Importance Of Subordination

The benefits to be obtained from making the tax laws governing securitization clearer and more accessible to more lenders and their tax counsel should be self-evident. Transactions will be structured more efficiently and with fewer transaction costs.

The benefits to be obtained from allowing somewhat greater issuance of subordinated debt securities are less obvious, but quite important and worth mentioning in some detail -- particularly since this is the principal part of the proposal that represents a change from current practice.

Under current law, as previously discussed, many asset-backed securities offerings must effectively be highly rated (i.e., "A" or better) in order to give comfort to cautious tax counsel. High ratings are desirable for other purposes as well, such as the goal of issuing as much of the securities at as low an interest rate as possible.

High ratings can often only be obtained with the assistance of external credit enhancement. This means some form of guarantee provided by an independent

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[4]See, Section 163(e)(5), Internal Revenue Code of 1986.

bank or other financial institution. Typically the guarantee -- which may take the form of a letter of credit or similar arrangement -- does not guarantee against all losses but assumes what is called a "second loss" position. This is comparable to the risks assumed by an insurer on a policy with a very large "deductible". Only when losses exceed a catastrophic level does the guarantee typically become applicable.

The losses being insured against by the credit enhancer, in effect, are not the normal risks of underwriting and making loans, but the risk, say, of an unanticipated severe recession which causes abnormally high levels of even soundly underwritten loans to go into default. In many respects, this is comparable to the type of risk that is borne by the FDIC with respect to conventional lending by commercial banks. The FDIC insures depositors against losses, but the FDIC is required to pay only if losses are so severe that they have depleted substantial portions of a bank's equity capital.

Because there is no Federal guarantee involved here, the entity providing the credit enhancement must have excellent credit itself. Typically this means that the credit enhancer must have a top investment rating, such as a long-term bond rating of AAA from Moody's Investor Servicers, one of several nationally recognized rating agencies. Certainly the rating on the securities receiving the guarantee can never be any better than the rating on the guarantor or other credit enhancer.

The need for credit enhancement has placed an increasing importance on what is, unfortunately, a limited and somewhat volatile supply of top rated financial institutions throughout the world. The number of triple-A rated commercial banks able to provide credit enhancement, for example, has declined substantially both in the U.S. and throughout the world as a result of the economic difficulties of the last decade.

We have prepared two other charts today which show the AAA-rated commercial banks in the U.S. and abroad in 1986 and 1993. These charts are reproduced at the end of the testimony. In 1986, there were 9 U.S. triple-A commercial banks. Today there are only two. This has meant an increasing reliance on foreign commercial banks as suppliers of credit enhancement. Even this supply has diminished and, perhaps more importantly, has become quite volatile. Foreign banks are no less subject to the vagaries of economic cycles than our own domestic financial institutions.

There has been much talk about the potential for the U.S. credit markets to become dependent upon foreign buyers of U.S. debt instruments. Much of the discussion has focused on an imagined scenario in which foreign investors stop buying U.S. Treasury obligations. For those who view loan securitization as a key financing technique, a more realistic threat may be posed by the growing dependence of U.S. lenders on a limited number of suppliers of credit enhancement. A major change in a single foreign government's bank rules, for example, could wipe 5 or 6 institutions off of the list of potential credit enhancers overnight. Such a scenario would substantially reduce credit availability for U.S. borrowers.

One alternative to credit enhancement in the form of guarantees is credit enhancement through further securitization. Instead of obtaining, say, a guarantee against $10 million of loan losses and paying a fee for that, the same economic function can be provided by raising $10 million in cash from the issuance of securities, conditioning the repayment of the $10 million upon losses not exceeding a particular level, and paying the security holders a higher interest rate to compensate them for assuming those risks. This is the economic function the newly authorized subordinated FASIT securities, with yields as high as 5 points over Treasury yields, are intended to serve.

By allowing this function to be provided through the nation's public securities markets, rather than through the issuance of guarantees by a limited number of

credit enhancers, the market of potential suppliers is immediately increased. It is potentially expanded rather dramatically from a fluctuating group of one or two dozen mainly foreign banks or other financial institutions to tens of thousands of sophisticated investors and money managers throughout the world.

In theory, opening up these markets occurs at the cost of a potential corporate income tax -- if one could assume that these functions would otherwise continue to be provided by corporations subject to U.S. taxation. But the unreliability of that assumption is the very problem. If we could be assured of high levels of credit availability, diversification, and liquidity without making any policy changes, there might be no need for legislation of this nature. However, we cannot simply take for granted a continued availability of capital for lending any more than we can take for granted the continued availability of gasoline or crude oil.

As the economy continues to improve, and loan demand increases, this problem may become even more severe than the "credit crunch" that has been experienced recently. Other solutions and approaches to provide securitization have been, and perhaps will continue to be, proposed. These may include easing various capital regulations, creating new Federal agencies to guarantee various types of loans, or even involving the U.S. government in direct lending. There is nothing inconsistent between FASIT and these other approaches. While some may have merit, it clearly makes sense to first go forward with what is a comparatively modest step of broadening the marketplace to allow institutional investors to invest more freely in subordinated loan-backed securities of the type authorized by the FASIT legislation.

Conclusion

In closing, let me summarize by saying that --

- Loan securitization is increasingly becoming the way U.S. corporations obtain funds for lending.

- As demonstrated with the experience under REMIC, securitization's benefits for the economy and the financial markets are widely accepted and understood.

- Greater clarity in the tax rules applicable to these transactions will help make them more efficient and less costly for all concerned.

- Through relatively modest tax changes we can also expand the number and type of participants that can provide the crucial function of credit enhancement -- making our domestic lending markets more "credit independent."

FASIT can accomplish these objectives, and we strongly support it for that reason.

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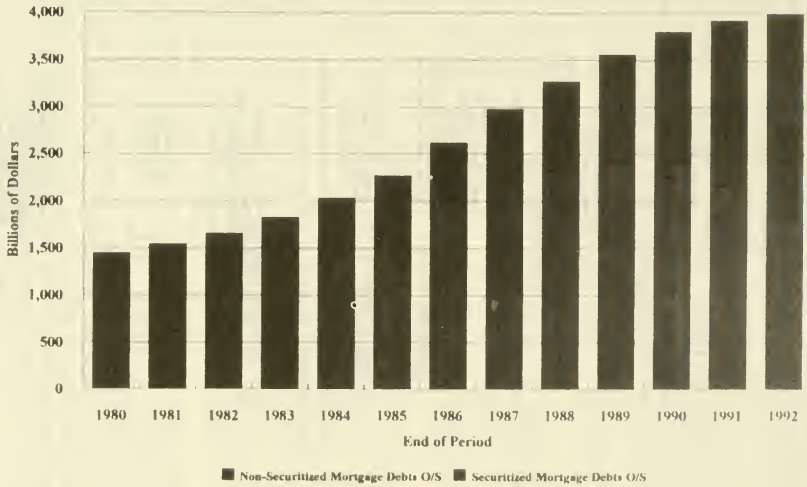
Securitization Increases Capital Availability



Source Federal Reserve Board (1992 data for Mortgage Debts O/S as of 6/30/92)
Inside Mortgage Finance Publications, Inc

Commercial Banks Rated "AAA" (Potential Credit Enhancers): 1986

U.S.	FOREIGN
	Banque Nationale de Paris
	Barclays Bank PLC
	Bayerische Landesbank Girozentrale
	Bayerische Vereinsbank A.G.
	Commonwealth Bank of Australia
	Credit Lyonnais
	Credit Suisse
	Dai-Ichi Kangyo Bank, Ltd.
	Deutsche Bank A.G.
	Fuji Bank, Ltd.
	Industrial Bank of Japan
	Kansallis Osake Pankki
	Long-Term Credit Bk. of Japan, Ltd.
	Mitsubishi Bank, Ltd.
	Mitsubishi Trust & Banking Corp.
Bankers Trust Company	National Westminster Bank PLC
Chase Manhattan Bank, N.A.	Norddeutsche Landesbank Girozentrale
Citibank, N.A.	Sanwa Bank Ltd.
Wachovia Bk & Tr. Co., N.A.	Societe Generale
Mellon Bank, N.A.	Sumitomo Bank, Ltd.
Morgan Guaranty Tr. Co. of NY	Sumitomo Trust and Banking Co.
Morgan Bank (Delaware)	Swiss Bank Corporation
Pittsburgh National Bank	Toronto Dominion Bank
Security Pacific National Bank	Union Bank of Switzerland

Source: *Moody's Long-Term Bank Ratings*

Commercial Banks Rated "AAA" (Potential Credit Enhancers): 1993

U.S.	FOREIGN
	Banque Francaise du Comm. Exter.
	Bayerische Landesanstalt fuer Aufbaufinanzierung
	Bayerische LFA Finance N.V.
	Bayerische Landesbank Gz
	Bayerische Vereinsbank A.G.
	Caisse Autonome de Refinancement
	Caisse des Depots
	Credit Local de France-Caeci
	Deutsche Ausgleichsbank
	Deutsche Bank A G
	Dresdner Bank A G
	Landesbank Hessen-Thuringen
	Kreditanstalt Fuer Wiederaufbaw
	Landeskredit Baden-Wuert
	Oesterreichische Kontrollbank
	Oesterreichische Postsparkasse
	Rabobank Nederland
	Rabohypotheekbank N.V.
	Suedwest LB
Morgan Guaranty Tr. Co. of NY	Union Bank of Switzerland
Morgan Bank (Delaware)	Z-Laenderbank Bank Austria AG

Source: *Moody's Long-Term Bank Ratings*

Mr. HOAGLAND. Let me talk a little bit about bank common trust funds with Ms. Kern and Mr. Manning for just a moment. Now, my understanding is that section 623 of H.R. 13 permitted the tax-free conversion of a bank common trust fund to a single mutual fund, is that right?

Ms. KERN. Yes, sir.

Mr. HOAGLAND. And under current law it is unclear as to whether the conversion of a trust fund into a mutual fund will be taxable as a transaction for the participants in the common trust fund?

Ms. KERN. It is my understanding that it would be treated as a taxable conversion.

Mr. HOAGLAND. It is clear that it would be treated as a taxable conversion.

Ms. KERN. Yes, sir.

Mr. HOAGLAND. And yet permitting the conversion of a common trust into a mutual fund is advantageous for both the participants in those funds and the banks that manage the funds, is that right?

Ms. KERN. Yes, sir.

Mr. HOAGLAND. And, as I understand it, you all would like to extend section 623 of H.R. 13 so it applies to more than a single mutual fund?

Ms. KERN. The conversion into more than one fund, yes, sir.

Mr. HOAGLAND. OK. Now, after H.R. 13 was introduced, why Congressman Coyne and I heard from a number of our smaller bankers, he in Pennsylvania and mine in Nebraska, advising us that it was critical that they be allowed to participate by converting their common trust funds into one or more mutual funds. In other words, the smaller banks didn't want to be limited.

I assume, Mr. Manning, that explains your presence here today representing the medium and small banks of Illinois?

Mr. MANNING. Yes, sir, it does.

Mr. HOAGLAND. And maybe you could give us just briefly the reasons for allowing conversion into more than one mutual fund.

Mr. MANNING. Well, the idea is that for a smaller institution, they simply cannot amass the amount of funds required for one mutual fund. This would give them the opportunity to go to a nonproprietary mutual fund and be able to take advantage of—on behalf of their customers—of the same benefits that a proprietary mutual fund would have for those larger institutions that are able to amass the amount of money necessary.

Mr. HOAGLAND. So you see the issue as one of equity between the larger and smaller banks?

Mr. MANNING. I beg your pardon?

Mr. HOAGLAND. You see the issue as one of equity between larger and smaller banks?

Mr. MANNING. I do.

Ms. KERN. I think you can also see it as an advantage to the customer because it provides the opportunity to divide the funds up into specialty funds, such as at AmSouth. We have bond funds, equity funds, and there is expertise in the management and the investment of those funds. So it is not necessarily just a small bank issue.

Mr. MANNING. Congressman, I agree with both points. I think both points together really sum it up.

Mr. HOAGLAND. OK. Now, Mr. Susswein, it seems to me that we are going to begin to see an increased recovery in our economy when small to medium banks increase their lending activities to small- and medium-sized businesses. It is these kinds of businesses, at least in my region of the country, that are ready to expand and hire people if they can obtain the funds for expansion.

Now, are you comfortable with the benefits of the FASIT legislation that you are advocating will be available to the small and medium bank sector as well as the larger banks?

Mr. SUSSWEIN. Oh, yes. First of all, they are going to be available to small businesses. One of the things we are seeing is that some of the securitization technologies that have developed are starting to be used for the pooling of small business loans.

As far as small- and medium-sized banks are concerned, one of the advantages for institutions is that, although there will be conduits, I am sure, that will pool together the portfolios of smaller institutions, the fact is that the small institution itself doesn't have to securitize in order for it to get the benefit of other institutions' securitizing. There is increased liquidity in the financial markets, created even if somebody else does the securitization.

There is also an increased ability to diversify your portfolio. You don't necessarily have to have a megabank come into your neighborhood to obtain diversification. Instead, you can simply invest in a portion of a portfolio originated by banks all over the country to get some of the benefits of diversification.

Mr. HOAGLAND. Now, is there some risk that this will favor standardized loan risks to the detriment of entrepreneurs?

Mr. SUSSWEIN. I don't think at this point the indications have been that there is a problem there. Certainly, the REMIC experience has increased the availability of mortgage money and not decreased it.

Mr. HOAGLAND. The REMIC experience has been highly favorable, hasn't it, nationwide?

Mr. SUSSWEIN. Definitely.

Mr. HOAGLAND. In terms of freeing up funds for additional mortgage loans?

Mr. SUSSWEIN. Yes. One of the key factors also is that the risk of investing is diversified. We can look at REMIC from the standpoint of the home buyer getting his or her money, but, as we all have seen from the S&L problems, there is also the point that you don't want to have any financial institution holding an undue concentration of risks, such as the S&Ls holding all the concentrated interest rate risk they held in the late 1970s and early 1980s.

The benefits of securitization are not only for the borrowers, but also for the financial system, because risk is diversified.

Mr. HOAGLAND. Now, this is a highly technical area. How are we coming in terms of negotiating the factual details with Treasury and others?

Mr. SUSSWEIN. Well, you will hear from Treasury next week, I understand. A number of very valuable suggestions and input have been made, not only by the Treasury but by the staff of the Joint Committee on Taxation. And both of those staffs proved crucial in the development of the workable REMIC legislation, and I am confident that, with additional suggestions from those staffs, the bill

will move forward, and we will have something that will be workable for everyone who is concerned.

Mr. HOAGLAND. And, as these meetings progress, we shouldn't lose sight of the big picture which is we can enhance the availability of credit to people in businesses without exposing the taxpayers to open-ended, unfunded contingency liabilities, is that right?

Mr. SUSSWEIN. I think that is the key point.

Mr. HOAGLAND. We have a real opportunity here, and we shouldn't let the details bog us down.

Mr. SUSSWEIN. That is true. Although details are important, and we are committed to working them through.

Mr. HOAGLAND. Very good.

Do any—it appears that no other panelists have any questions at this time, so thank you everyone. We would thank the four of you for attending.

We are moving right along now. I appreciate your succinctness and clarity with which you presented your positions.

Ms. KERN. Thank you.

Mr. HOAGLAND. Mr. Eliasberg, I will give Mr. Cardin a full account.

Mr. ELIASBERG. Thank you.

Mr. HOAGLAND. Now I would welcome panel five. We have Richard O'Toole from the Battle Fowler law offices in New York; Tab Buford from City National Bank of Newark; William Rudin from the National Realty Committee; Thomas McChesney from Grubb & Ellis in Pittsburgh; and James Sheridan of the National Retail Federation.

Mr. O'Toole, you are recognized for 3 minutes.

STATEMENT OF RICHARD L. O'TOOLE, PARTNER, BATTLE FOWLER, NEW YORK, N.Y.

Mr. O'TOOLE. Thank you.

Good afternoon. My name is Richard O'Toole. I am a partner in the law firm of Battle Fowler, New York, N.Y., and I appreciate the opportunity to testify this afternoon concerning H.R. 2065, the FASIT legislation.

We believe that the creation of a new vehicle that will provide predictable and equitable tax treatment for securitization transactions, thereby enhancing liquidity in the capital markets, is a highly desirable objective, and we therefore strongly support H.R. 2065.

The legislation accomplishes the objectives of providing certainty because of the uniform tax rules that apply and the efficiency in that minimum capital levels are not needed in order for investments to be treated as debt for Federal income tax purposes.

In addition to the more specific technical comments included in our written submissions, we have the following two general observations:

First, as a policy matter, we believe that a judgment should be made as to whether the tax-exempt character of interest received on municipal bonds held by a FASIT should be passed through to the holders of interests in FASIT. There appears to be no reason why, as in the case of a partnership or a fixed investment trust,

a flowthrough of the tax-exempt character of the interest should not be available.

Indeed, the very fact that the underlying interest is exempt greatly reduces any possibility of tax deferral or tax avoidance.

If tax-exempt bonds are to be included in FASITs, protective features should be included similar to that in strip legislation to assure that tax-exempt interest is not created. It should also be clear that the transfer of a tax-exempt bond to a FASIT and the creation and sale of an interest in a FASIT does not result in a reissuance of the tax-exempt bonds.

Statutory rules that apply to holders of tax-exempt bonds such as the interest disallowance rules of section 265 should also apply to holders of interest in FASITs.

Our second general comment relates to a principal advantage that we believe is inherent in this proposal. It is that, unlike REMIC legislation, it does not require that the securitization of all assets in a FASIT be effected through a FASIT format. Although the statutory scheme for REMICs includes a taxable mortgage pool concept, which mandates the use of REMICs for securitizing mortgage obligations, a similar provision for FASITs would be inappropriate because of the wide range of debt instruments that may be included in a FASIT and the adverse impact on capital markets that would result if all nonmortgage securitizations had to be effected through a single vehicle that was not proven to be workable for all transactions within its intended scope.

Thank you.

Mr. HOAGLAND. Let me at this point note for the record that Mr. Payne from Virginia will take over presiding over this hearing.

Let me tell you, Mr. O'Toole, this detailed and thorough legal analysis you present I know is going to be very helpful as we develop this FASIT proposal.

Mr. O'TOOLE. Thank you.

[The prepared statement follows:]

BATTLE FOWLER
280 PARK AVENUE
NEW YORK, N.Y. 10017
(212) 856-7000
FACSIMILE (212) 856-5135
WRITER'S DIRECT DIAL NUMBER
(212) 856-7198

Submission of Richard L. O'Toole of Battle Fowler concerning H.R. 2065, being considered by the House Ways and Means Subcommittee on Select Revenue Measures June 17, 1993

A. Summary

1. General. The creation of a new vehicle that will provide predictable, equitable tax treatment for securitization transactions, thereby enhancing liquidity in the capital markets, is a desirable objective. We support H.R. 2065. The legislation, as drafted, accomplishes the objectives of providing certainty (because of the uniform tax rules that apply) and efficiency (in that minimum capital levels are not needed in order for investments to be treated as debt for income tax purposes). As noted below, a number of technical issues need to be explored, and in doing so, any possibility of simplifying portions of the legislation should be pursued.

2. Exclusivity. A principal advantage inherent in this proposal is that it does not require that the securitization of all assets that could be included in a FASIT be effected through the FASIT format. Although the statutory scheme for REMICs includes the taxable mortgage pool concept, which mandates the use of REMICs when securitizing mortgage obligations, a similar provision for FASITs would be inappropriate because of the wide variety of debt instruments that may be included in a FASIT, the significant technical vetting that will be needed in order for the FASIT structure to be a practical alternative to existing securitization structures, and the adverse impact on capital markets that would result if all non-mortgage securitizations had to be effected through a single vehicle that was not workable for all transactions within its intended scope.

3. Tax-Exempt Obligations. The legislation should clarify whether a FASIT can be used to hold tax-exempt obligations and pass through the tax-exempt status of interest, pursuant to Section 103 of the Internal Revenue Code, to holders of equity interests in the FASIT. Changes to the existing language in H.R. 2065 would have to be made to cause the tax-exempt status of interest recognized by the FASIT to pass through to classes of ownership interests.

4. Technical Analysis. The operational provisions included in H.R. 2065 are complex and incorporate rules and concepts from a number of other tax areas. The discussion set forth below analyzes these rules and raises a number of specific questions concerning their scope and effect.

B. Discussion/Analysis

1. General. The purpose of H.R. 2065 is to provide a vehicle through which securitization transactions may be effected with predictable tax results, without an entity level tax and without any inappropriate tax deferral or tax avoidance -- all facets of the overall objective of enhancing liquidity in the capital markets and decreasing the cost of capital. We have the following observations concerning the overall scope and intent of this legislation:

(a) As in the case of REMICs, the availability of a structure that is specifically authorized by legislation, allows entity-level taxation to be avoided, contains clear-cut rules, and does not impose a minimum capital requirement should enhance the liquidity and efficiency of the capital markets.

(b) If enacted, FASITs may become the vehicle of choice through which a wide variety of securitization, risk sharing, and derivative transactions are effected. Consideration should therefore be given to the impact H.R. 2065 may have on current discussions concerning topics such as the disclosure standards that should apply in the case of derivative transactions and the application of recent regulatory changes interpreting the Investment Company Act of 1940.

(c) The FASIT rules should provide adequate safeguards against tax avoidance because of the requirement that income earned by the FASIT be allocated to taxpaying entities and that the interest rate on debt instruments not exceed 5 percentage points in excess of the yield on comparable Treasury securities. We suggest that consideration be given to whether, in at least some cases, the permitted rate in excess of the comparable Treasury rate at which debt instruments can be issued should be increased, particularly in light of the historically low current interest rates on Treasury securities and the significant volume of distressed loans that could benefit from the enhanced liquidity that FASITs offer. One approach would be to allow for a higher rate, such as 8 percentage points in excess of the applicable Treasury rate, if the instrument satisfies other criteria, such as a maturity date of less than 15 years and/or minimum amortization.

2. Exclusivity. H.R. 2065 does not include a provision analogous to Section 7701(i), the taxable mortgage pool rules that apply to REMICs and that require that mortgages be securitized in a REMIC structure. We believe that adding such a provision and thereby compelling the use of a FASIT structure for any securitization that includes a substantial percentage of assets that may qualify for FASIT treatment would be mistaken, for the following reasons:

(a) We endorse strongly the absence of a rule comparable to Section 7701(i) because, upon the enactment of H.R. 2065, there will be a significant amount of fine-tuning that can be expected to occur during the next several years, as the FASIT rules are tested in the market. During this inevitable period of trial-and-error, the liquidity of the markets will be dependent upon the flexibility afforded by structures other than FASITs.

(b) Even if a significant period of delay were built into the application of any rules like the taxable mortgage pool rules, the FASIT rules are fundamentally different than the REMIC rules because the FASIT rules apply to all categories of debt obligations, rather than a single category.

(c) Finally, the relevance of the taxable mortgage pool rules themselves should be clarified. The FASIT rules apply to debt obligations, which may include mortgage obligations within the purview of both the REMIC rules and the taxable mortgage pool rules. As a result, an entity that holds mortgage obligations and elects FASIT treatment would appear to fall within the taxable mortgage pool rules -- and as a result would be taxable as a corporation -- because it would not have elected REMIC treatment. This appears to have the effect of precluding FASIT treatment for mortgages. If this is intended, we suggest a clarification be made to the effect that any pool of mortgage obligations that cannot qualify for REMIC treatment will not be subject to the TMP rules if FASIT treatment is elected. Alternatively, if this result is not intended, we suggest that the TMP rules be inapplicable if REMIC or FASIT treatment is elected.

3. Tax-Exempt Obligations. In its current form, H.R. 2065 does not address whether FASITs will be appropriate vehicles through which tax-exempt obligations may be securitized. As a policy matter, a judgment should be made as to whether the tax-exempt character of interest received on bonds held by the FASIT should be passed through to holders of interests in the FASIT. There appears to be no reason why, as in the case of a partnership or fixed investment trust, a flow through of the tax-exempt character of the interest should not be available. Indeed, the very fact that the underlying interest is exempt greatly reduces the possibility of tax deferral or tax avoidance, and any mechanism that reduces the cost of tax-exempt capital should be favored.

(a) Protective features should be included in the legislation to assure that tax-exempt interest is not "created" -- i.e., there should not be an ability for any investors to recognize more tax-exempt interest than is paid on the underlying bonds.

(b) It should be clear that the transfer of a tax-exempt bond to a FASIT and the creation and sale of interests in a FASIT does not result in a reissuance of the tax-exempt bonds. A reissuance of tax-exempt bonds would typically result in either a termination of the tax-exempt status of the interest or a requirement to undertake steps that satisfy rules for current refundings.

(c) Statutory rules that apply to holders of tax-exempt bonds, such as the interest disallowance rules of Section 265(2), should apply to holders of interests in FASITs to the extent tax-exempt interest is passed through to FASIT holders.

(d) The ability of individuals to own preferred interests in FASITs that own tax-exempt bonds could be a favorable method of securitizing tax-exempt bonds, thereby reducing the cost of capital to State and local governments.

4. Technical Analysis. The analysis set forth below is a section-by-section commentary on the operational provisions of H.R. 2065. Preliminarily, because of the scope of H.R. 2065, its technical complexity, and the brief notice period for this hearing, we strongly urge this legislative effort to enlist the assistance of Bar Associations that frequently comment on proposed tax legislation.

855A(a)(3): The assets of a FASIT may consist of all debt instruments. Clarification should be added to address the interplay of FASIT rules with REMIC provisions and the taxable mortgage pool rules. Among the issues to be addressed are whether a REMIC may be a FASIT, whether an entity that would otherwise be treated as a taxable mortgage pool can elect to be a FASIT, and whether a regular REMIC interest is a debt obligation for this purpose.

It would be helpful if the scope of the term "money" were clarified. Does this include actual cash, amounts in checking accounts, bank money market funds and money market mutual funds (which technically are shares of stock)?

855A(a)(4)(A): This subsection requires that the governing documents of the FASIT prohibit (A) the acquisition and disposition of assets, other than in accordance with the terms and conditions set forth in the agreements pursuant to which qualified debt instruments and ownership interests are issued, (B) the acquisition or disposition of assets for the primary purpose of recognizing gains or decreasing losses from changes in market values and (C) the acquisition of a debt obligation for the primary purpose of realizing income from property acquired in connection with a default of the debt obligation.

These rules should be clarified to address whether they are exclusively organizational requirements -- which must be present in the governing instruments, but are not tested on an operational basis -- or both organizational and operational. The use of the term "primary purpose" in clauses B and C should also be clarified, in order to avoid disputes as to which of several potential meanings are to apply to these terms. The prohibition in subsection C against acquiring defaulted debt obligations for the primary purpose of realizing income from the property that secures the debt obligation may prevent the use of FASITs to securitize distressed loans -- an area of the economy as to which enhanced liquidity and reduced costs of capital should be an important objective. It is preferable for the possibility that a FASIT will acquire collateral securing a loan to be dealt with through the prohibited transaction mechanism, rather than by raising an issue as to the overall pass-through status of the FASIT.

855A(a)(6): It should be made clear that one or more classes of preferred ownership interests may be issued by a FASIT.

855A(b)(1): Because a FASIT is not treated as a corporation, partnership or trust for any purpose, the reporting requirements that apply to FASITs should be specified.

855A(b)(2): The reference to Section 1722(a)(6) appears to be a typographical error, and should refer to Section 1272(a)(6).

855A(b)(6): These basis adjustment rules should track more closely the basis adjustment rules of Section 705 -- which take into account exempt income and nondeductible expenses.

855A(b)(7)(B): A clarification should be added to the effect that any disallowed loss should be available to offset the gain on disposition of the ownership interest, and not be carried over to the transferee.

855A(c)(2): The permitted maturity date for a qualified debt instrument of 15 years should be extended. A wide variety of commercial loans secured by property other than real estate may have maturities in excess of 15 years, such as loans used to finance aircraft and ships.

855A(c)(3): A clarification should be added that this provision does not prevent debt instruments with net profits interests (i.e., kickers) from being acceptable assets for a FASIT.

855A(c)(4): This provision appears to permit the FASIT to issue qualified debt instruments and to strip interests in such debt by the issuance of ownership interests in principal and/or interest payments "as would be permitted in the case of a fixed investment trust holding such qualified debt instruments."

These rules should address whether the creation of the ownership interests cause the stripped bond rules to apply. The reference to fixed investment trusts may not be a sufficiently clear reference as to the type of stripped investments that are permitted, in light of the uncertainty as to various issues under Section 301.7701-4(c) of the Treasury regulations.

A FASIT is able to treat the rights arising out of the same qualified debt instrument as a single qualified debt instrument. Does this mean that the stripping rules do not apply to the FASIT but could apply to the holder?

855A(d): Preferred ownership interests have debt-like features but cannot be issued at a premium and have no yield to maturity limitations. If FASITs will be available for tax-exempt bonds, the parameters of preferred ownership interests should be expanded to allow for a pass-through of the tax-exempt character of interest on the bonds.

855C(b)(1): Is this provision suggesting (or indicating) that when a transferor sells its interest in a FASIT, the sales proceeds are treated as principal payments received by the FASIT on the transferred assets, with the resulting premium, original issue discount or market discount consequences?

855G(a): A policy decision should be made as to whether the enhanced liquidity objectives of the FASIT rules should apply to loans secured by distressed properties. If so, clarification should be added to the effect that, merely by acquiring high-risk loans, these prohibited transaction rules should not apply even if a loan is included in a FASIT and, shortly thereafter, property that secures the loan is acquired by the FASIT. An alternative approach would be to provide FASITs with more flexibility in acquiring distressed loans, and requiring that collateral that is subsequently acquired by the FASIT be promptly disposed of, and/or subject to the rules for foreclosure property, as drafted.

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Mr. HOAGLAND. Mr. Payne.
Mr. PAYNE [presiding]. Thank you very much.
Mr. Buford, if you would proceed please.

STATEMENT OF SHARNIA "TAB" BUFORD, CHAIRMAN OF THE BOARD, CITY NATIONAL BANK OF NEWARK, N.J.

Mr. BUFORD. Thank you very much, Mr. Chairman. I appreciate the opportunity to speak with you concerning the lack of capital in the inner cities and minority communities.

My testimony will focus on the extent of the problems impeding access to capital for minority-owned and inner city businesses. I will testify about certain tax incentives for minority-owned financial institutions which, if implemented, will go a long way toward resolving some of these problems.

For the past 5 years I have been working as a banking consultant. My expertise is in the area of bank organizations, development and management, strategic planning and turnaround systems for banks in crisis and troubled situations. I am currently the chairman of the board of City National Bank of Newark, the only minority-owned bank in the State of New Jersey.

If the legislative proposals I testify in support of today are acted upon by this committee and the Congress and implemented by the administration, I genuinely believe that over time you will see a true rebirth of the inner cities. This will occur through the creation and expansion of minority banking which will provide a vehicle on a national basis to alleviate the desperate need of capital in minority communities in this country.

The resolution of failed thrifts and banks by the RTC and FDIC invariably results in the closure of branch locations in minority communities. Hundreds of locations were closed in connection with those cases that were liquidated. This does not include the closing of branches by an acquiring institution after it had been acquired by RTC and closed down.

During the last 10 to 15 years, numerous institutions closed the majority of their inner city branches, thus deterring the flow of capital to these communities, once economically healthy communities.

For the most part, minority-owned financial institutions have unique customer bases. Their customers maintain relatively low balances. They tend to write more checks. Most corporate accounts are small businesses with a high volume of accounts.

Most minority bank customers visit their branch offices at least on a weekly basis, utilizing tellers in the lobby areas. Minority banks, in particular, normally have higher employee/deposit ratios due to safety reasons.

This is not the targeted customer base for majority banks. Most majority banks are attempting to divest themselves of this high-cost customer base of activity.

According to the Federal Reserve, there are only about 125 minority-owned banks and thrifts operating in the United States today. This is the same number there were approximately 20 years ago, mostly small with assets under $100 million.

Capital starvation in the inner city is not a new problem. According to a Wall Street Journal report on June 11, 1992, only 2 of the

roughly 50 major banks in the Washington, D.C. area maintain branches in the business district of Anacostia and neither had a lending officer.

The Washington Post recently chronicled the discrimination against minority borrowers at local banks as well as the lack of access to capital and full service branches in minority communities in the Washington, D.C. area.

During the 1970s, banks began an exodus from neighborhoods like these, says John Caskey, a Swarthmore College economist who has researched patterns of bank branch closings. He found that 23 percent of the richer neighborhoods had bank branches in 1970, and that rose to 43 percent in 1989. But only 18 percent of the poor census tracts had branches in 1970, and that fell to 14 percent in 1989. There is a clear avoidance of minority neighborhoods by these large banks.

The number of check-cashing stores across the Nation has doubled over the past 5 years to about 4,300 today. Check cashers took in approximately $710 million in fees during 1990. Pawn shops charged interest rates as much as 20 percent per month.

Filling the void left by banks in the inner city is a growing business. Some bank capital does trickle down in the inner city through high-priced lending.

Some big banks recently settled charges with the Massachusetts Attorney General for accusing them of financing unconscionable loans. According to the State, the big bank provided lines of credit to crooked second mortgage companies that were charging exorbitant rates in deals aimed at repossessing homes.

While the FDIC and RTC have diligently pursued the sale of financial institutions previously owned by minorities to like minority groups, their record in maintaining the character of these institutions has been far less than stellar. In the case of RTC, some limited interim capital assistance has been made available. The FDIC does not even participate in this program.

Realistically though, who else other than a minority investor group or a minority-owned financial institution would likely purchase such an institution? Given the weak capital base they have in the economy, many of these failed institutions are simply liquidated by RTC or FDIC.

While the enactment of the Community Reinvestment Act of 1979 by Congress was supposed to prevent discriminating lending practices, there is strong and persuasive evidence that the lending institutions still discriminate against predominantly minority groups.

On October 21, 1991, the Federal Financial Institution Examination Council announced the availability of data relating to 1990 mortgage lending activities in metropolitan areas across the country. In 19 large cities that were examined, Boston had the highest rejection rate for blacks, which amounted to 34.9 percent. Houston had the highest rejection rate for Hispanics, which amounted to 25.7 percent.

The results of the 1991 data released in October 1992, showed virtually no progress over the previous year. In 1991, the mortgage rejection rate for blacks was 37.6 percent, which was 2.17 times the 17.3 percent rate for whites.

It is not possible to determine whether loan applications were being treated fairly on a racially nondiscriminatory basis. However, the Federal Reserve Bank of Boston did conduct its own survey of 4,000 applications in 1992 and did take into account the applicant's credit as well as debt-to-income ratio and many other considerations. This study found that, even after accounting for all such issues, black mortgage applications were being rejected about 1.6 times as often as whites.

The quality of life in minority communities bears a direct relationship to the adequate availability of credit to those neighborhoods and the small businesses located within those communities. Unless something is done, the climate will arrive to repeat the Los Angeles tragedy in inner cities across the country.

The current trends in our population will only make matters worse for minority communities in the United States. New 1990 census figures show a dramatic emergence of minority groups in all areas of the country for the past decade. The U.S. population living in all metropolitan areas totals approximately 193 million, an increase of just over 20 million, 11.6 percent, since 1980.

The population living outside metropolitan areas total approximately 56 million, increased by only 2.1 percent.

Mr. PAYNE. Mr. Buford, if I can interrupt, we will put this entire statement into the record, and if you want to then conclude, because the time has expired.

Mr. BUFORD. OK, Mr. Chairman. I just need a couple more minutes, if I could.

What do all of these facts really mean? (*a*) Discriminatory lending practices known as redlining are still predominant in minority communities in America today. (*b*) Financial disenfranchisement of minority communities is worsening, due in part to the closing of banks in minority neighborhoods by FDIC and RTC and majority-owned banks. (*c*) The majority of the next generation of Americans will be comprised of minorities. (*d*) The migration and immigration of minorities to metropolitan areas will continue at a very rapid pace during the next 20 to 30 years. Some 80 to 85 percent of the total population will reside in metropolitan areas, and the majority of these people will be minorities. (*e*) Unless something is done to reverse the trend, the minority migrating to urban centers will live at below the poverty level, and this will create a huge drain on resources of the Federal Government.

The RTC minority preference resolutions enacted under title IV of the RTC Refinancing, Restructuring and Home Improvement Act of 1991 created acquisition opportunities for minority-owned financial institutions, either newly chartered or existing, to acquire failed thrifts from RTC, with RTC providing capital assistance to minority acquirers.

This year, Congressman Mfume has introduced several amendments to the RTC Completion Act which will establish a preference and priority in favor of minority acquirers seeking to purchase failed thrifts or branches thereof located in predominantly minority neighborhoods.

As a companion to this bank-related legislation, the following three proposed tax-related amendments are needed in order to provide necessary incentives to raise the capital required for the char-

tering of a new minority-owned financial institution and to shelter earnings in these institutions, which, when added to capital, will allow additional substantial lending in minority communities.

Number one, when the FDIC, RTC or NCUA award failed financial institutions to minority-owned financial groups, the tax law should be amended as follows:

Permit minority-owned financial institutions or their holding companies that purchase failed financial institutions, or branches thereof, from FDIC, RTC or NCUA to assume the tax loss carryforward of the acquired failed institution, or the pro rata portion of the same in the case of a branch purchase, retroactive to the effective date of FIRREA.

Additionally, any tax loss carryforward acquired by minority-owned financial institutions pursuant to this section could be passed through to an additional minority-owned financial institution acquiring such minority-owned financial institution through sale or merger.

Two, when the FDIC, RTC or NCUA award failed financial institutions to minority-owned financial institutions, the tax loss should be amended in the following way:

In the event minority-owned financial institutions or their holding companies offer common stock or preferred stock or other similar equity instruments to the public, the amount of purchase of such equity instrument shall be tax deductible, retroactive to the effective date of FIRREA.

When the FDIC, RTC, NCUA have awarded a failed financial institution to minority-owned financial institutions, the tax laws should be amended to permit accelerated depreciation on fixed assets.

In summary, Mr. Chairman, let me reiterate that the lack of access to capital is a key impediment to the economic growth and economic opportunities in the inner city minority communities. We need more financial institutions and particularly more commercial banks serving our community.

We hope to improve and increase opportunities for minority businesses in the inner cities. If we want economic opportunity to increase and to endure in inner city minority communities, we need more and larger financial institutions whose growth and future is tied to that community. Factually speaking, this means more and larger minority-owned financial institutions.

Thank you, Mr. Chairman and members of the committee for this opportunity to share my views. I will be happy to respond to any questions that you might have.

Mr. PAYNE. Thank you very much, Mr. Buford.

[The prepared statement and attachments follow:]

TESTIMONY OF SHARNIA "TAB" BUFORD
HOUSE OF REPRESENTATIVES
HOUSE SUBCOMMITTEE ON SELECT REVENUE MEASURES
JUNE 17, 1993

Mr. Chairman, I appreciate the opportunity to speak with you concerning the lack of capital in the inner-cities and minority communities. My testimony will focus on the extent of the problems impeding access to capital for minority-owned and inner-city businesses, the systemic factors contributing to these problems and the consequences resulting from the lack of sufficient capital in the inner-cities and minority communities. Finally, I will testify about the regional, state and national implications involved with the lack of capital for minorities and speak directly to certain tax incentives for minority-owned financial institutions which, if implemented, would go a long way toward resolving these problems.

I would like to begin by identifying what I perceive to be the underlying problems responsible for the shortage of capital in minority communities, then I will address the potential consequences which we must all face if we do nothing and maintain the status quo. Finally, I will attempt to explain why I feel that the implementation of certain tax incentives for minority-owned financial institutions will promote investments by individuals and corporations in minority-owned financial institutions and also shelter capital in these institutions which will provide more money for lending in minority communities in the United States.

For the past five or six years I have been in the bank consulting business. My expertise is in the areas of bank organization, development and management, strategic planning and turnaround systems for banks in crisis and troubled situations. I am also the Chairman of the Board of City National Bank, a minority-owned bank in Newark, New Jersey.

I am the recipient of many distinguished awards including the United Negro College Fund Meritorious Award, Dr. Martin Luther King, Jr Humanitarian Award, White House Small Business Award, Outstanding and Distinguished Black Business Person of the Year Award presented by The Kansas City Globe and the U.S. Jaycees Distinguished Service Award.

If the legislative proposals I testify in support of today are acted upon by this Committee and the Congress and are implemented by the Administration, I genuinely believe that over time you would see a true rebirth of the inner cities. This would occur through the creation and expansion of minority banking which would provide the vehicle, on a national basis, to alleviate the desperate need for capital in minority communities in this country.

PROBLEMS RESPONSIBLE FOR LACK OF CAPITAL IN MINORITY COMMUNITIES

The Financial Disenfranchment of Minority Communities

Reduction of Banking Services

The resolution of failed thrifts and banks by the RTC and FDIC invariably results in the closure of branch locations in minority communities. A review of branch closings from institutions liquidated by RTC since its inception reveal that hundreds of locations were closed in connection with those cases that were liquidated. This does not include the closing of branches by an acquiring institution after it has acquired a franchise from the RTC nor does it include similar figures from the resolution of failed banks by FDIC. With the current trend of mergermania among the large money center and regional banks in the United States, this problem will only be magnified.

During the last 10 to 15 years, following the exodus of the affluent and the mostly white middle class to the suburbs, numerous lending institutions closed the majority of their inner city branches. This deterred the flow of credit to these communities. The limited flow of credit led to the decline of once economically healthy communities throughout the United States. White flight is continuing from the inner cities across the county.

For the most part, minority-owned institutions have unique customer bases. Their individual deposit customers maintain relatively low balance accounts. Many are welfare recipients or receive other government subsidies or are retired. They tend to write more checks on these low balance accounts due to personal security reasons involving the handling of cash in minority neighborhoods. Most of their corporate accounts are small businesses which also maintain low balances but are high volume accounts. Most minority-bank customers visit their bank offices at least on a weekly basis, utilizing tellers in the lobby area, again, for security reasons. Other accounts, such as minority churches and fraternal organizations constitute their larger deposit account customers. Minority banks in particular normally have higher employee/deposit ratios due to the character of their deposit customer base.

This is not the targeted customer base for majority banks. Most majority banks are attempting to divest themselves of this high cost customer base as they are, for them, unprofitable accounts. Therefore, minority-owned banks are serving an increasing segment of the population who, through the imposition of increasing service charges and other fees as well as the closing of branch facilities, would find themselves without a financial services provider.

Shortage of Minority-Owned Financial Institutions in the U.S.

According to the federal Reserve, there are only about 125 minority-owned banks and thrifts are operating in the United States today. This is about the same number of minority-owned financial institutions as there have been for the last 20 years. Most are small, with assets below $100 million.

Capital starvation in the inner city is not a new problem, of course, but in many areas it seems to have worsened in recent years. Statistics are hard to come by, but evidence of the problem is available to anyone really interested in the problem. According to a Wall Street Journal report in the June 11, 1992 edition, it was reported that only two of the roughly 50 major banks in the Washington, D.C., area maintain branches in the business district of Anacostia and neither has a lending officer. The Anacostia area is located only about a mile from Capital Hill across the Anacostia River. Across town, in the aging commercial corridor of Columbia Heights, which was among the neighborhoods hit by three nights of rioting after a police shooting last year, there is only one bank branch. President Clinton, while campaigning in the Washington area last summer, cited the lack of bank branches east of the Anacosta River as a root of urban problems. President Clinton recently told a Rainbow Coalition luncheon that investing in minority neighborhoods is not simply the right thing to do morally and politically, it also makes good economic sense. The Washington Post recently chronicled the discrimination against minority borrowers at local banks as well as the lack of access to capital and full service branches in minority communities in and around Washington D.C.

During the 1970's banks began an exodus from neighborhoods like these, says John Caskey, a Swarthmore College economist who has researched patterns of bank branch closings. In the five cities Mr. Caskey studied the total number of bank branches rose to 447 in 1989 from 302 in 1970, but banks pulled out of poor neighborhoods as they opened branches in wealthier communities. He found that 23% of richer neighborhoods had bank branches in 1970, and that rose to 43% in 1989. But only 18% of the poor census tracts had branches in 1970, and that fell to 14% in 1989. "There is a clear avoidance of minority neighborhoods," Mr. Caskey says, "that shows up even after adjusting for income."

The federal government and some cities have fitfully tried to channel credit into distressed neighborhoods, but inner-city entrepreneurs, perhaps even more than those elsewhere, are deeply distrustful of public-sector solutions. Rather than handouts from politicians and bureaucrats, say business owners in inner-city neighborhoods, what they want is simply a chance to get the same deal that businesses elsewhere expect: A little capital at market rates, and a few basic financial services.

Too frequently, when credit is made available to minority businesses, the interest rates border on being usurious. Sometimes simply putting together the documentation for a loan deters minorities from dealing with banks.

The proliferation of such high-cost competitors, from pawn shops to fly-by-night lenders to high-priced finance companies, provides another indirect indicator of the retreat of banks from minority communities.

The number of check-cashing stores across the nation has doubled over the past five years to about 4,300. Check-cashers, which usually charge 2% or more of the face amount of a check, took in about $790 million in fees during 1990, according to a trade group estimate. Pawn shops charge interest rates of as much as 20% a month.

Filling the void left by banks in the inner city is a growing market. Major corporations earn huge fees performing rudimentary financial services. Western Union, a unit of Upper Saddle River, N.J. based New Valley Corp., has expanded into check cashing, and plans to build a network of 500 to 1,000 check-cashing outlets. The net income of Big Board-listed Cash America International Inc., a chain of pawn shops, has doubled in the past four years to $10.5 million.

Some bank capital does trickle into the inner city through higher-priced lenders, though not necessarily in a beneficial manner. Several big banks recently settled charges with the Massachusetts attorney general, who accused them of financing "unconscionable loans." According to the state, the big banks provided lines of credit to crooked second-mortgage companies that were charging exorbitant rates in deals aimed at repossessing homes.

Here in Washington, one unregulated finance company, the locally owned Latin Investment Corp., went belly up last year and took with it $6 million in savings from 3,000 local residents, mostly Salvadorans. It's a measure of how few lenders there are that the company, despite all the losses it caused, is remembered in the heavily Latino Adams Morgan neighborhood for loaning money to several local Salvadoran restaurants.

Of course, there is an array of government programs, federal, state and local. But, in many cases, the experiences of inner-city business owners with those programs has been "horrific," says Michael Crescenzo, vice president of Arch Development Corp., a nonprofit development company funded by a local utility company.

Failure of RTC and FDIC to Promote the Increase of Minority Banking

While the FDIC and RTC have diligently pursued the sale of financial institutions previously owned by minorities to like minority groups, their record in maintaining the character of those institutions has been less than stellar. Their charge from Congress and their own internal policies is to attempt to maintain the status quo. When a minority institution is placed into conservatorship, there is an attempt made to market the institution to a like minority investor group or financial institution. While this is notable and, in the case of the RTC, some limited interim capital assistance has been made available, the FDIC does not even participate in this program. RTC has resolved 26 minority institutions to date. Five cases utilized Interim Capital Assistance with total loans of $6,260,000.

Realistically though, who else other than a minority investor group or minority-owned financial institution would likely purchase such an institution? There are only limited programs designed to encourage minority groups to purchase non-minority failed institutions which could then open branches in minority communities and restore financial services which are declining rapidly in these communities. Additionally, given the weak capital base many minority banks have in the current economy, many of these failed institutions are simply liquidated by RTC or FDIC and the branches are closed due to a lack of interest or financial capacity from potential bidders.

Discriminatory Lending Practices - Federal Reserve Report

One of the main causes contributing to the financial disenfranchisement of minority communities is the continued discrimination in lending practices, known as redlining, which has long been prevalent in minority communities across the county. While the enactment of the

Community Reinvestment Act (CRA) in 1977 by Congress was supposed to prevent discriminatory lending practices, there is strong and persuasive evidence that lending institutions still discriminate against predominantly minority communities.

On October 21, 1991, The Federal Financial Institutions Examination Council (FFIEC) announced the availability of data relating to 1990 mortgage lending activity in metropolitan areas the across the country. The Federal report examined 6.5 million loan applications made by whites and minorities at 9,000 banks in 24,000 metropolitan statistical areas. I have submitted a summary of the results of the Federal Reserve Study with my written testimony.

In 19 large cities examined, Boston had the highest rejection rate for blacks, 34.9 percent, and Washington, D.C., the lowest, 14.4 percent. Houston had the highest rejection rate for Hispanics, 25.7 percent, and Minneapolis the lowest, 8 percent.

The results of the 1991 data released in October of 1992 showed virtually no progress over the previous year. In 1991, the mortgage-denial rate for blacks -37.6%- was 2.17 times the 17.3% rate of whites. The black-white ratio improved somewhat from 2.35 in 1990. Of Hispanic applicants, 27.3% were rejected. That was 1.54 times the white rate, up from 1.49 in 1990. Asian/Pacific Islanders constitute the only racial group showing much improvement over 1990.

It is not possible to conclusively determine from the Home Mortgage Disclosure Act data alone whether loan applicants are being treated fairly and on a racially nondiscriminatory basis. The data reveal little about financial characteristics of loan applicants - only their annual income. The report does not include information about asset levels, existing debt burdens, credit history, employment experience and prospects as well as repayment history. According to an article in American Banker, this study does confirm a pattern of racial bias among mortgage lenders in the Boston area.

However, the Federal Reserve Bank of Boston did conduct its own study of 4,000 applications in 1992 that did take into account the applicants' credit history, as well as debt-to-income ratios and many other considerations. This study found that even after accounting for all such issues, black mortgage applicants were being rejected about 1.6 times as often as whites.

While these reports may not serve as absolute evidence of discrimination in mortgage lending, it clearly shows that there is a monumental problem with the availability of home mortgage credit in minority communities. The chairman of the House Banking Committee, Representative Henry B. Gonzales, D-Texas, responding to the Federal Reserve report in a letter to President Bush stated, "It matters not whether the discrimination is intentional. Discrimination by ignorance is just as hurtful and destructive as discrimination by design."

The quality of life in minority communities has eroded because the vitality of these neighborhoods bears a direct relationship to the adequate availability of credit to those neighborhoods and the small businesses located in these communities. Unless something is done to reverse the trend, the limited availability of credit and simple banking services such as checking and savings accounts, safe deposit boxes, etc., in minority neighborhoods will continue to worsen in the coming years and, as a consequence, so will the quality of life. As a result, the climate will be ripe for a repeat of the Los Angeles tragedy in the inner-cities all over the country.

MINORITY POPULATION TRENDS AND WEALTH DISTRIBUTION

Population Trends

In addition to the historical problem of racial discrimination in lending and in providing the most rudimentary levels of banking services in minority communities, it is clear that the current trends in our population will only make matters worse for minority communities in the United States. The United States now is more racially and ethnically diverse than at any time in its history.

New 1990 Census figures show a dramatic emergethnicity of minority groups into all areas of the country over the past decade. The trend even holds true among blacks, historically the most racially isolated group.

The proportion of U.S. residents identifying themselves as white declined to 80.3% in 1990 from 83.1% in 1980. Blacks became a larger segment of the U.S. population increasing to 12.1% in 1990 from 11.7% in 1980. The proportion of Hispanics increased to 9% in 1990 from 6.4% in 1980. Asians and Pacific Islanders grew to 2.9% of the population from 1.5% ten years ago. Native Americans increased to 0.8% from 0.6%. Other races grew to 3.9% of the population. The population as a whole increased 9.8% to a total of 248,709,873 people.

More important than the current percentage of the various races comprising the population is the rate at which all of the different segments grew over the last ten years. The following table illustrates the level of growth for each racial group:

Group	1990 Population	Growth Since 1980
All Races	248,709,873	9.8%
White	199,686,070	6.7%
Black	29,986,060	13.2%
Hispanic	22,354,059	53.0%
Asian/Pacific Islander	7,273,662	107.8%
Native American	1,959,234	37.9%

(Source: United States Census Bureau)

The 1990 Census showed some interesting characteristics about the population. California, Texas and Florida, Hispanic and Asian strongholds, accounted for half of the United States population growth over the last decade, compared to 33% in the 1960's and before. One in four Californians and Texans is Hispanic, as are one in three New Mexico residents. Yet, New Jersey has more Hispanics than either New Mexico or Arizona. Fifty three percent of blacks live in the South. But black gains were the highest in the West, up 25%. The white population grew at less than two-thirds the United States rate of 9.8% because of lower fertility rates, low immigration and higher death rates. The median age for the white adult population is 41.3 years of age. The median age for adult blacks and Hispanics is 33.3 and 33.9 years of age, respectively.

Another interesting development which the 1990 census discloses is that the United States population living in all metropolitan areas totals 192,725,741, an increase of just over 20 million (11.6%) since 1980. These same areas grew 10.6% in the 1970's. The population living outside metropolitan areas totals 55,984,132, increasing by only 2.1 million (3.9%) in the 1980's. The metropolitan population now constitutes 77.5% of the United States total population, compared to 76.2% in 1980. Ninety percent of the Nation's growth in the 1980's took place in metropolitan areas.

Minorities make up 50% or more of the population in 51 of the largest cities (population of at least 100,000) in the United States. My handwritten testimony includes a current listing of these cities and the aggregate minority population in each city.

Census Bureau predictions released in December, 1992, indicate that the minority groups in the United States will collectively make up approximately 50% of the nation's population by the year 2050. The Census says that the white population would decrease from 75% to 53% by the year 2050. The projected population would be 383 million people of which 53% would be white, 21% Hispanic, 15% black, 10% Asian and 1% would be Native American. Higher rates of minority births and immigration are the main reasons cited for these projections.

Disparity of Wealth

American households have a median net worth of approximately $36,000. White households' median net worth is 10 times that of blacks: $43,000 versus $4,000. The net worth of Hispanic-origin households is not considered significantly different than that of blacks: $5,500. The most affluent fifth of White households have a median net worth of $120,000; the comparable figures for affluent Black and Hispanic-origin households are $47,000 and $58,000 respectively. The most startling statistic in this area however is the comparison of net worth of the lowest one-fifth of White households, with net worth in the range of $9,000, to the lowest fifth of Black households, where one-half of these constituents had either zero or negative net worth. Hispanic households in the same segment had net worth of about $400, not significantly different from that of Blacks. (Source: Census Bureau report, Household Wealth and Asset Ownership: 1988).

CONSEQUENCES OF INACTION

What do all of these facts and figures mean? There are some conclusions which can clearly be drawn:

(a) Discriminatory lending practices known as redlining are still very predominant in minority communities in America today.

(b) Financial disenfranchisement of minority communities is worsening today due in part to the closing of banks in minority neighborhoods by FDIC and RTC, and majority-owned banks because of mergers and acquisitions.

(c) The majority of the next generation of Americans will be comprised of minorities. The White population will be in the minority.

(d) The migration and immigration of minorities to metropolitan areas will continue at a very rapid pace during the next 20 to 30 years. Easily 80% to 85% of the total population will reside in metropolitan areas and the majority of these people will be minorities.

(e) Unless something is done to reverse the trend, the minorities migrating to urban centers will live at or below the poverty level; and this will create a huge drain on the resources of the Federal Government to fund housing projects, aid to the homeless, drug programs, police and security enforcement and numerous other programs.

The consequences of inaction will only mean more civil unrest in our cities. Positive action is needed now.

SOLUTIONS TO THE PROBLEM

Private Sector Assistance

There has been some response from the private sector to the need minority-owned financial institutions have for capital. Mr. Ray Chambers, an extremely successful businessman in Neward, NJ., and First Fidelity Bancorp have provided capital assistance to our bank, City National Bank, in Newark. Bank of America and ARCO have committed to purchase preferred stock in Founders National Bank of Los Angeles. Founders was featured earlier this month as the Black Enterprise Financial Company of the Year. Keystone Holdings, a company controlled by financier Robert Bass purchased stock in Family Savings Bank, a minority-owned thrift in

Los Angeles. Boston Bank of Commerce recently sold some of its stock to four major banks in the Boston area. No doubt there are other examples of private sector assistance but, notwithstanding this limited investment from the private sector, much more needs to be done in order to fully address the need for capital in minority-owned financial institutions which serve minority neighborhoods. For every $1 million of capital, either contributed or sheltered, a minority-owned bank is enabled to make an additional $20 million in loans.

Government Action

Enactment of Tax Incentives For Minority-Owned Financial Institutions

RTC Minority Preference Resolutions enacted under Title IV of the RTC Refinancing, Restructuring, and Improvement Act of 1991, created acquisition opportunities for minority-owned financial institutions, either newly chartered or existing, to acquire failed thrifts from the RTC with the RTC providing capital assistance to the minority acquirors. This year Congressman Mfume has introduced several amendments to the RTC Completion Act (HR 1340) which would establish a preference and priority in favor of minority acquirors seeking to purchase failed thrifts, or branches thereof, located in predominantly minority neighborhoods. As a companion to this bank-related legislation the following three proposed tax-related amendments are needed in order to provide necessary incentives to raise the capital required for the chartering of new minority-owned financial institutions and to shelter earnings in these institutions which, when added to the capital, will allow additional substantial lending in minority communities.

Legislative Proposals

1.) When the FDIC, RTC OR NCUA award failed financial institutions to minority-owned financial institutions, the tax laws should be amended in the following way:

> Permit minority-owned financial institutions or their holding companies that purchase failed financial institutions, or branches thereof, from FDIC, RTC or NCUA to assume the tax loss carryforward of the acquired failed financial institution, or the pro-rata portion of same in the case of branch purchases; retroactive to the effective date of FIRREA. Additionally, any tax loss carryforward acquired by a minority-owned financial institution pursuant to this section, could be passed through to additional minority-owned financial institutions acquiring such minority-owned financial institution through sale or merger;

2.) When the FDIC, RTC or NCUA award failed financial institutions to minority-owned financial institutions, the tax laws should be amended in the following way:

> In the event minority-owned financial institutions or their holding companies offer common stock or preferred stock or other similar equity instruments to the public, the amount of the purchase of such equity instruments shall be tax deductible; retroactive to the effective date of FIRREA.

3.) When the FDIC, RTC or NCUA award failed financial institutions to minority-owned financial institutions, the tax laws should be amended in the following way:

> Permit minority-owned financial institutions that acquire such failed financial institutions, or branches thereof, pursuant to this section from FDIC, RTC and NCUA to use accelerated depreciation on all fixed assets and leasehold improvements purchased; retroactive to the effective date of FIRREA.

CONCLUSION

In summary, Mr. Chairman, let me reiterate that the lack of access to credit is a key impediment to economic growth and economic opportunity in inner city minority communities. We need more financial instutions -- and particularly more commercial banks -- serving our communities if we hope to improve and increase opportunities for minority businesses in inner cities. If we want ecomonic opportunity to increase and endure in inner-city minority communities, we need more and larger financial instituions whose growth and future is tied to these communities. Practically speaking this means more and larger minority-owned institutions.

Thank you again, Mr. Chairman, and members of the Committee for this opportunity to share my views. I would be happy to answer any questions.

Federal Reserve Report

Income*	Applicant	Government-backed				Conventional			
		Approved	Denied	With drawn	File Closed	Approved	Denied	With- Drawn	File Closed
Less than 80%	American Indian Alaskan native	63.5%	26.5%	9.2%	0.9%	62.7%	27.7%	8.8%	0.9%
	Asian/Pacific isl	75.0	13.9	10.3	0.9	68.4	17.2	13.4	1.0
	Black	58.5	29.4	10.7	1.4	51.4	40.1	7.6	0.9
	Hispanic	66.5	22.4	9.8	1.3	58.1	31.1	9.8	1.0
	White	76.5	14.7	8.0	0.8	69.0	23.1	7.2	0.7
	Other	67.7	21.3	10.2	0.8	64.5	26.1	8.3	1.1
	Joint (white/ minority)	74.1	17.3	8.0	0.6	64.8	26.3	8.0	0.9
80% to 99%	American Indian/ Alaskan native	70.2%	17.8%	11.1%	0.8%	73.3%	16.6%	9.4%	0.7%
	Asian/Pacific isl	78.4	12.7	8.4	0.6%	75.1	13.7	10.5	0.7
	Black	64.5	24.8	9.5	1.2	60.8	29.3	8.9	1.0
	Hispanic	72.2	17.0	9.9	0.8	67.7	21.5	10.1	0.7
	White	81.0	10.6	7.7	0.7	78.1	13.7	7.6	0.6
	Other	72.0	13.5	13.0	1.6	70.6	21.1	7.6	0.7
	Joint (white/ minority)	78.2	13.0	6.2	0.6	72.2	18.0	9.1	0.8
100% to 120%	American Indian/ Alaskan native	68.0%	17.0%	13.6%	1.5%	72.6%	14.0	12.7	0.8
	Asian/Pacific isl	78.1	12.4	9.2	0.4	75.0	12.6	11.5	0.9
	Black	65.7	23.1	10.1	1.1	63.8	26.3	9.3	0.7
	Hispanic	73.9	14.7	10.3	1.1	69.6	19.1	10.4	0.9
	White	81.9	9.5	8.0	0.7	80.4	11.2	7.8	0.6
	Other	69.6	15.0	14.7	0.7	72.1	18.0	9.2	0.7
	Joint (white/ minority)	77.6	12.9	8.5	1.0	75.8	15.0	8.6	0.6
More than 120%	American Indian/ Alaskan native	71.3%	15.6%	12.5%	0.7%	74.4%	12.8%	11.9%	0.9%
	Asian/Pacific isl	76.0	11.2	12.0	0.8	75.2	11.2	12.9	0.7
	Black	68.0	20.8	10.3	1.0	65.7	21.4	11.6	1.3
	Hispanic	72.4	14.2	12.4	1.0	71.1	15.8	12.2	1.0
	White	82.4	8.6	8.3	0.7	81.2	8.5	9.7	0.6
	Other	67.3	17.1	13.7	2.0	71.0	15.8	12.5	0.8
	Joint (white/ minority)	79.2	10.6	9.4	0.7	77.6	10.5	11.3	0.7

* As a percentage of the median family income of the metropolitan statistical area in which the property related to the loan is located. Source: Federal Reserve

The results of the Federal Reserve study on a city by city basis reveal the following:

Federal Reserve Report
How Mortgage Rejection Rates Vary by City
Percentage of Applications denied*

	Asian	Black	Hispanic	White	Unknown	Total
Atlanta	11.1%	26.5%	13.6%	10.5%	17.9%	13.8%
Baltimore	7.3	15.6	10.1	7.5	8.9	8.6
Boston	15.4	34.9	21.2	11.0	19.5	12.9
Chicago	10.4	23.6	12.1	7.3	16.0	9.9
Dallas	9.3	25.6	19.8	10.7	15.4	12.5
Detroit	9.1	23.7	14.2	9.7	18.7	11.7
Houston	13.3	33.0	25.7	12.6	18.8	15.5
Los Angeles	13.2	19.8	16.3	12.8	21.9	14.7
Miami	16.9	22.9	17.8	16.0	26.3	18.0
Minneapolis	6.4	19.9	8.0	6.1	22.0	7.1
New York	17.3	29.4	25.3	15.0	19.3	18.7
Oakland	11.6	16.5	13.3	9.6	19.0	11.4
Philadelphia	12.1	25.0	21.0	8.3	17.8	11.3
Phoenix	12.8	30.0	25.2	14.4	26.2	16.4
Pittsburgh	12.2	31.0	13.9	12.0	24.7	13.3
St. Louis	9.0	31.8	13.5	12.1	16.8	14.0
San Diego	11.2	17.8	15.1	9.8	20.4	11.4
Seattle	11.6	18.3	16.8	10.7	19.3	11.8
Washington, D.C.	8.7	14.4	8.9	6.3	10.2	8.2

*Data refer to one-to four-family homes purchased with conventional, FHA, FMHA, and VA mortgages. Refinancings not included. Source: Federal Financial Institutions Examination Council.

Cities In Which Minorities Constitute A Majority

City	Minority Percentage	City	Minority Percentage
East Los Angeles, Calif.	97.2%	Salinas, Calif.	61.3%
Laredo, Texas	94.4%	Elizabeth, N.J.	60.3%
Inglewood, Calif.	91.5%	Houston	59.6%
Hialeah, Fla.	89.1%	Richmond, Va.	57.1%
Miami	87.8%	New York	56.8%
Gary, Ind.	85.9%	Jackson, Miss.	56.6%
El Monte, Calif.	84.8%	Stockton, Calif.	56.4%
Newark, N.J.	83.5%	Memphis	56.4%
Detroit	79.3%	Corpus Christi, Texas	56.2%
Santa Ana, Calif.	76.9%	San Bernardino, Calif.	54.5%
Paterson, N.J.	75.6%	Bridgeport, Conn.	54.4%
Honolulu	74.5%	Vallejo, Calif.	53.8%
El Paso	73.6%	Savannah, Ga.	53.8%
Washington	72.6%	San Francisco	53.4%
Pomona, Calif.	71.8%	Pasadena, Calif.	53.4%
Oakland, Calif.	71.7%	Macon, Ga.	53.2%
Atlanta	69.7%	Ontario, Calif.	53.0%
Hartford, Conn.	69.5%	Dallas	52.3%
Oxnard, Calif.	67.7%	Cleveland	52.2%
New Orleans	66.9%	Flint, Mich.	51.7%
Birmingham, Ala.	64.2%	New Haven, Conn.	51.0%
San Antonio	63.8%	Fresno, Calif.	50.6%
Jersey City	63.4%	Long Beach, Calif.	50.5%
Los Angeles	62.7%	San Jose, Calif.	50.4%
Chicago	62.1%	Chula Vista, Calif.	50.2%
Baltimore	61.4%		

(Source: U.S. Census Bureau as reported in USA Today, December 4, 1992)

Mr. PAYNE. Mr. Rudin.

STATEMENT OF WILLIAM C. RUDIN, CHAIRMAN, TAX POLICY COMMITTEE, NATIONAL REALITY COMMITTEE, AND EXECUTIVE VICE PRESIDENT, RUDIN MANAGEMENT CO., NEW YORK, N.Y.

Mr. RUDIN. Mr. Chairman, members of the Ways and Means Committee, good afternoon. My name is William Rudin. I come to you as chairman of the National Realty Committee and as chairman of the Tax Policy Advisory Committee. I am also executive vice president of the Rudin Management Co., which is a family-owned firm, real estate firm in New York City. We own and manage approximately 7 million feet of office space, all in Manhattan, divided equally between lower Manhattan and midtown, and approximately 22 apartment buildings with 3,000 units.

I am a third generation of the family to be involved with the firm. My grandfather started the business in the early 1920s, and followed by my father and uncle. I represent, as I mentioned, third generation. On behalf of the National Realty Committee, I appreciate the opportunity to present testimony today regarding the cost recovery rules of leasehold improvements. These rules are important in terms of tax policy, jobs, and urban center revitalization. We are pleased that this subcommittee is reviewing these rules for possible corrective legislation.

In addition to your interest in this area, Mr. Chairman, we are also appreciative of the interest shown in the issue by Representatives Andrews, Jefferson, and Lewis. My statement will contain three components. First, I will explain what a leasehold improvement is. Second, I will briefly outline the effects of current tax law, and finally I will offer some suggestions for correcting this.

What is a leasehold improvement or tenant improvements or simply TI is what we call it in the business? It is in essence what makes an office an office—walls, ceilings, lighting, partitions, plumbing, finishes, duct work, things like that. Though most of us don't give it a thought, office retail and other rental real estate is typically reconfigured, changed or somehow improved on a regular basis to suit the needs of new and existing tenants. Let me briefly take you through a process of how we make a deal in this environment today.

Over the last 4 or 5 years it is very difficult to close a lease. I just finished a deal that took literally 1 year to negotiate and the tenant will not be in occupancy of that space probably until the end of the year, because now we are in the point of time of building out the space. We negotiated a lease, we agree on the rent, the term, and a major component is how much money the owner contributes to building out these finishes. We agree on that or work out a work letter which details these items. The tenant hires an architect, an engineer who gives us these plans. We then go out and competitively build it and build the space. This is all documented in the lease that we have signed.

Today's designs of interior space are much more energy efficient. They are designed to increase worker productivity, and they are also designed to comply with the American Disabilities Act for handicapped accessibility. They are also better in terms of life

safety. Most offices have sprinklers, sophisticated communication and smoke detectors installed in them. The cost of these improvements in New York City where I am from typically range between $45 and $50 a foot, and they represent a cost of doing business over the term of the lease, and they should properly be treated as such. Unfortunately they are not.

Instead of matching the recovery of the leasehold improvement expense to the life of the improvements, today's rules dictate that such expenses be recovered over depreciable life. Today 31½ years, and in the recent bills 39 or 38, depending on what happens over the next few weeks. These rules misstate economic reality. They do not reflect the true life of these improvements which usually run the lease term, but can sometimes be shorter as space may be rebuilt several times under the terms of the lease to suit a particular tenant's changing needs or when a space becomes vacant due to bankruptcy.

Compounding today's problems regarding the unrealistic long-term period over which leasehold improvements costs are to be recovered is a significant ambiguity surrounding how a real estate owner accounts for leasehold improvements that are demolished before the end of that prescribed recovery period in order to make way for a new tenant, or because the existing tenant, as I mentioned before, may go bankrupt.

What is the fallout of today's rules? To begin with, the aftertax cost of reconfiguring a building out space to accommodate a new tenant is artificially high. Because the owner is unable to fully deduct the economic cost extended on the leasehold improvements over the improvement's useful life, the owner's income is artificially inflated for tax purposes. Like factories have to be rebuilt, so do our office buildings. They have to be retooled to be competitive in this changing economy that we live in.

To make matters worse, the current policy hinders urban renewal and construction job opportunities as improvements are delayed, or not undertaken at all. We are fortunate. My family has been able to keep our mortgages low, and we have the capital to be able to fund these tenant improvements. At a recent meeting I was at with construction trade union members, where we talked about easing work rules to help reduce some of these costs, the fact came out that between 50 and 70 percent of their members are on the bench, which means they are unemployed. They have been hit very, very hard by this recession.

In addition, when we design the space, as I think I mentioned before, it becomes more energy efficient, environmentally sound, and if these things—if it is not made to make economic sense, these things will not happen.

Finally, I would like to point out to the extent that the current policy serves as a disincentive for real estate investment and compounds the effect of today's real estate crisis by further destabilizing commercial real estate values for which the 1990s—so far in the 1990s we estimate about $500 billion nationwide. If you look in today's Washington Post, Mayor Kelly talked about reducing her employment by 1,700 to fill in a $150 million budget gap. If you continue on in the article the reason there is a $150 million budget gap is because their revenue estimates from real estate taxes have

precipitously dropped, and in lower Manhattan we have about 30 million feet of vacant space out of an inventory of about 90 million.

Lower Manhattan has the third largest central business district in the country behind midtown Manhattan, 250; Chicago, 100 million; then lower Manhattan, 90. Lower Manhattan has been decimated by cuts in the service industries and other companies who have laid off people or moved out of the city. The impact on the local tax revenue has been dramatic. I believe the City of New York has lost about $400 to $500 million this year in tax revenues.

What is the answer to this issue? From our perspective, the recovery of expenses associated with the construction of assets should closely match the period of time the assets produce income. Therefore, in the case of leasehold improvements, the ideal recovery period would be for the lease term plus reasonable additional lease extensions. This is not a radical idea. Prior to 1981 that was the law. Alternatively a new separate depreciable class for leasehold improvements, longer than the typical lease term of 5 to 7 years to account for the probability of lease renewals, but shorter than today's 31½ years would be a significant step in the right direction.

In addition, the close out issue, which I noted earlier, should be addressed. At the point that the asset no longer exists, there should be no reason why the remaining unrecovered costs should be deductible. The law clearly allowed this before, prior to 1981. In conclusion, Mr. Chairman, the National Realty Committee strongly commends the policy initiatives relating to real estate that are currently included in the House-passed budget reconciliation bill. Nonetheless, we would urge that this committee and Congress also reform the cost recovery of tenant improvements. Such action would without a doubt help stabilize today's diminished commercial real estate asset values and as a result help set a Nation on a course of sustained economic recovery and long-term growth.

Thank you. I would be happy to answer any questions.

Mr. PAYNE. Thank you very much, Mr. Rudin.

[The prepared statement follows:]

STATEMENT OF THE NATIONAL REALTY COMMITTEE

TO THE COMMITTEE ON WAYS AND MEANS

SELECT REVENUE MEASURES SUBCOMMITTEE

U.S. HOUSE OF REPRESENTATIVES

REGARDING

THE COST RECOVERY OF LEASEHOLD IMPROVEMENTS

William C. Rudin
Chairman
Tax Policy Advisory Committee
National Realty Committee

June 17, 1993

Mr. Chairman, members of the Ways and Means Committee, good afternoon. My name is William C. Rudin, and I am chairman of the Tax Policy Advisory Committee of National Realty Committee (NRC).

NRC serves as Real Estate's Roundtable in Washington on national issues affecting real estate. Its members are America's principal commercial and multifamily real estate owners, advisors, builders, investors, lenders and managers.

Our company, Rudin Management Company, Inc., which I serve as executive vice president, manages over seven million square feet of office space and over 3,000 apartment units in New York City. It's because of my experience day-to-day in real estate management and in understanding the needs of today's office tenants that I am here today to testify on an issue of significant concern to real estate, America's cities, and the approximately seven million workers engaged in building and construction trades nationwide.

We very much appreciate the opportunity to present testimony today regarding the cost recovery rules for leasehold improvements. These rules are important -- in terms of tax policy, jobs and inner-city revitalization -- and we are very pleased this subcommittee has included proposals to revise the existing rules on its list of items to be reviewed for possible corrective legislation. In addition to your interest and concern in this area, Mr. Chairman, we're also very appreciative of the interest shown in this issue by Representatives Michael Andrews (D-TX), William Jefferson (D-LA) and John Lewis (D-GA).

National Realty Committee's View -- A Brief Summary

Our message today is simple and straightforward: Today's tax policy governing the recovery of costs associated with constructing leasehold improvements misstates economic reality, and as such inhibits employment opportunities, discourages environmentally efficient building improvements and discourages the revitalization of America's inner-cities. Instead of a building owner recovering the expenses incurred to construct leasehold improvements over the life of the *constructed leasehold improvement*, today's rules dictate that such expenses be recovered over the life of the *overall building*, which is now depreciated over 31.5 years and is proposed in the House-passed Budget Reconciliation bill (H.R. 2264) to be depreciated over 39 years.

This approach to leasehold cost recovery was not always the tax law; and, we believe, revisions to the current rules should be made. What should be done to remedy this situation? In theory, tax policy should allow for the recovery of leasehold improvement expenses over the lease term, as the law allowed prior to 1981. We recognize that this "life of the lease" approach may present some complexity, and may be more difficult to administer. Therefore, we also could support the establishment of a new, separate depreciable life for leasehold improvements.

Compounding today's problem regarding the unrealistic time period over which leasehold improvement costs are required to be recovered, is significant ambiguity surrounding how a real estate owner accounts for leasehold improvements that are demolished, before the end of the prescribed recovery period, in order to make way for a new tenant. Prior to 1981 it was clear that an owner could deduct the remaining unrecovered cost in the year in which the improvement was demolished. Beginning in 1981, and certainly since 1986, whether the owner has retained this ability is unclear in many circumstances.

In addition to establishing a more realistic recovery period for leasehold improvements generally, from NRC's point of view, policy also should leave no doubt that once the asset no longer exists, the unrecovered cost of the improvement should then be "closed-out" and deducted currently.

What is a Leasehold Improvement?

When we talk about leasehold, or tenant, improvements, we are talking about what makes an office an office: internal walls, ceilings, partitions, plumbing, lighting and finish.

Though most of us don't give it a thought, office, retail and other rental real estate is typically reconfigured, changed or somehow improved on a regular basis to suit the needs of new and existing tenants.

In fact, building occupants often expect property owners to make tenant-specific internal improvements when a new lease is signed and thereafter. And building owners typically comply as a function of doing business.

In practice it's a relatively simple matter: A tenant signs a lease. The building owner makes improvements. The tenant occupies the space for a number of years. And the owner makes more improvements to suit the tenant's evolving needs. The cost recovery of tenant improvements should be equally apparent -- and accurately reflected in the tax code. Unfortunately, it's not.

Instead of matching leasehold improvement expenses incurred by a building owner generally to the life of the improvements, today's rules dictate such expenses be recovered over the life of the overall building, which must be depreciated over 31.5 years. In doing so, today's rules misstate economic reality by not reflecting the true life of these improvements, which is usually the lease-term but can sometimes be shorter as space may be rebuilt several times under the terms of the lease to suit a particular tenant's needs. And, as pointed-out above, compounding this mismatch of leasehold improvement expenses and leasehold improvement income is significant ambiguity surrounding what the proper tax treatment is, and should be, for any unrecovered expense at the time that the leasehold improvement is demolished by the owner.

The Fallout of Today's Flawed Policy

What's the fallout of today's flawed policy in this area? To begin with, the after-tax cost of reconfiguring, or "building-out", space to accommodate a new tenant is artificially high. Because the owner is unable to fully deduct the economic costs expended on leasehold improvements over the improvements' useful life, the owner's income is artificially inflated for tax purposes.

To make matters worse, the current policy hinders urban renewal and construction job opportunities as improvements are delayed or not undertaken at all. As New York Mayor David Dinkins put it recently, "Like factories in need of retooling so they can produce the most advanced kinds of products, many buildings today need to be retooled to produce the environment necessary to house and grow businesses of the future.

"How do we encourage these necessary, high-performance leasehold improvements that will help renew our urban areas and create jobs in the process? A national tax system that recognizes the true useful lives of these improvements would be a good place to start."

Mayor Dinkins isn't alone is in his thinking. Edward J. Malloy, president of the Building and Construction Trades Council of Greater New York, concurs.

"As I see it," Malloy said earlier this year, "this is a jobs issue. Especially given the absence of new building in many markets, opportunities for construction jobs in the next decade will largely be tied to the renovation and rehabilitation of existing space.

"To the extent a more rational system of depreciating these costs would encourage additional improvements and higher-grade alterations, construction jobs will be assured -- perhaps even more jobs will be created."

A widespread shift to more energy-efficient, environmentally sound building elements also is discouraged as these improvements often carry a heftier price tag. Additionally, to the extent that the current tenant improvements tax policy serves as a disincentive for real estate investment, it compounds the effects of today's real estate crisis by further destabilizing commercial real estate asset values, which so far in the 1990's have fallen by about $500 billion, according to DRI/McGraw-Hill, with negative consequences for local governments, financial institutions and taxpayers.

For these reasons, National Realty Committee believes the tax treatment of tenant improvements should be rationalized to reflect what is generally the true life of the improvements.

An Historical Perspective on the Issue:
Why Economic Cost Recovery is Fundamental

Historically speaking, the concept of economic cost recovery is fundamental to the integrity of America's tax system. True net income is determined by recovering the costs expended on an investment over the same period of time as the investment earns income. This "matching" precept has long been embedded in the tax code.

Prior to the Economic Recovery Tax Act of 1981 ("1981 Act"), a building owner was generally entitled to recover the costs associated with constructing leasehold improvements over their useful lives, such as the term of the lease for which they were constructed. Appropriately, this policy reflected the fact that improvements constructed for one tenant are rarely suitable for another, and that when a tenant leaves, the space is typically built-out all over again (or at least substantially renovated) for a new tenant.

With the 1981 Act, however, the concept of matching income from the lease with the costs of leasehold improvements was set aside as the system of component depreciation for real estate was abandoned.

In an effort to simplify depreciation laws, a single depreciation life of 15 years was established for buildings and leasehold improvements made to them by owners.

Since the 1981 Act, however, the recovery period for nonresidential real property has been lengthened to 18 years, to 19 years and, finally, to 31.5 years under the Tax Reform Act of 1986. (The House-passed Budget Reconciliation legislation (H.R. 2264) extends the cost recovery period for nonresidential property to 39 years.) With these depreciation changes, however, has come no distinction between the capital cost recovery of buildings themselves and the periodic internal improvements made to accommodate specific tenants.

Thus, in the relatively short time between 1981 and 1986, the tax treatment of leasehold improvements dramatically changed from a flexible depreciation system that sought to accurately match income with expenses to a system that dictates a recovery of expenses over a period that in no way reflects the useful life of these improvements. In light of this situation, now is an opportune time to revisit and modify these rules, which over time have been increasingly problematic.

Solving the Problem

What should be done to address this issue?

From NRC's perspective, rational tax policy dictates that the recovery of expenses associated with the construction of an asset should closely match the period of time that the asset produces income. Therefore, in the case of leasehold improvements, the ideal recovery period should be the lease term, plus reasonable additional lease extensions, as was the law prior to 1981. Alternatively, a new separate depreciable class for leasehold improvements -- longer than the typical lease term of 5 to 7 years to account for the probability of lease renewals, but shorter than today's 31.5 years -- would be a significant step in the right direction.

In addition, the "close-out" issue noted earlier in this statement should be addressed. At the point at which an asset no longer exists, there is no rational reason, in our view, why the remaining unrecovered costs shouldn't be deductible currently. The law clearly allowed for this deduction prior to 1981. The law clearly allows tenants who build-out their own improvements to recover any remaining unrecovered costs when they terminate a lease. However, the law for owners is ambiguous and should be clarified to provide the same treatment allowed tenants.

Conclusion

National Realty Committee strongly commends the policy initiatives relating to real estate that are currently included in the House-passed Budget Reconciliation bill (H.R. 2264). Nonetheless, we would urge that this Committee and Congress review one additional area not addressed by these initiatives: the cost recovery of tenant improvements. Such action would, without a doubt, help stabilize today's diminished commercial real estate asset-values and, as a result, help set the nation on a course for sustained economic recovery and long-term growth.

Thank you.

Mr. PAYNE. Mr. McChesney.

STATEMENT OF THOMAS B. McCHESNEY, PRESIDENT-ELECT, BUILDING OWNERS & MANAGERS ASSOCIATION INTERNATIONAL, AND EXECUTIVE VICE PRESIDENT AND DISTRICT MANAGER, GRUBB & ELLIS CO., PITTSBURGH, PA.

Mr. MCCHESNEY. Thank you very much, Mr. Payne, and good afternoon. My name is Tom McChesney. I am the executive vice president and district manager for the Pittsburgh, Pa., office of Grubb & Ellis Co., which is the largest publicly held, full service real estate company with offices nationwide. I am here today representing the Building Owners & Managers Association International—BOMA. Our membership controls over 5 billion square feet of U.S. commercial office space.

Next week I will be installed as BOMA International's president, and I look forward to serving my industry and working with you in that capacity.

Today I am here to address the issue of depreciation for leasehold improvements. As my colleague from the National Realty Committee has explained, the tax treatment of tenant improvements is seriously flawed. Instead of matching improvement expenses to the life of the improvements, present tax law requires that such expenses be recovered over the life of the whole building. This means that today's cost recovery occurs on a schedule of 31½ years, and, as we have heard before, current tax discussions underway in Congress may extend cost recovery even further—upward of 38 years.

Before the tax changes in 1981, there was a reasonable policy whereby leasehold improvements could be recovered over the useful life of those improvements. After the 1981 Tax Act, improvement costs had to be recovered over the same depreciation period as the building, which at that time was 15 years. The 1986 Tax Act changed the depreciation schedule for buildings to 31½ years. Since leasehold improvements were unfortunately tied to building depreciation, the recovery for those improvements was also extended to 31½ years.

If this linkage remains, we can expect to see that a change in depreciation under this year's tax bill will carry with it a much longer depreciation schedule for buildings and therefore an even longer cost recovery schedule for tenant improvements. That is the source of our concern. In a typical office building, tenant improvements paid for by the owner are undertaken when a tenant signs a lease to occupy a space. These improvements range from simple painting of partitions and interior walls to customized business environments. The improvements are what makes an office an office. For example, when 110 new Members of Congress came here this year, a large number of tenant moves and changes took place in the House office buildings. Because of the configuration of these offices, the age of the buildings, and the interior structure of the office space, tenants were probably moving in furniture and files and painting. However, district offices may have required significant alterations to accommodate the incoming members. Transforming a dentist's office into a congressional office takes some time and work and a lot of investment. Demolition of walls and all sorts of work

is necessary. In as few a 2 years, the space may have to be refurbished again for a new occupant. Therefore the tenant improvements are not retained for even close to 31½ years. If that is the case for a district office of 2,000 square feet, imagine the build out required for a space of 20,000 square feet in the commercial market.

With landlord-provided construction of almost a half million dollars required by a tenant for build out, the depreciation issue becomes clear. Before anyone occupies newly leased space, lighting must be installed, office partitions must be built, electrical changes made, and so forth. With typical leases ranging from 5 to 10 years, and bank loans or any other financing for those improvements being paid over the same term, the depreciation system is dramatically out of sync. The recovery of expenses for leasehold improvements in no way reflects the useful life of these improvements nor the time in which loans are being repaid.

Instead, what we find is an unfair tax policy which has shifted as a result of the 1981 and 1986 tax bill. The recovery period for tenant improvements should reflect the useful life of the improvements constructed. One recommendation is to tie the cost recovery period to the life of the lease term. Depreciation should be tied to the expected life of the purchase. Over a 31½-year period, a typical office could be reconfigured three or four times. Unfortunately, when a tenant moves out after 10 years, you still have 21½ years of depreciation yet to be taken on that space.

On behalf of the office building industry across the United States, we ask that this tax treatment of tenant improvements be reexamined and modified. BOMA International is prepared to assist you and this subcommittee in your efforts to address this issue. Thank you.

Mr. PAYNE. Thank you very much, Mr. McChesney.

[The prepared statement follows:]

TESTIMONY OF TOM McCHESNEY
BUILDING OWNERS AND MANAGERS ASSOCIATION INTERNATIONAL

Good afternoon. My name is Tom McChesney. I am Executive Vice President and District Manager for the Pittsburgh office of Grubb & Ellis Company -- the largest publicly-held, full-service real estate company with offices nationwide. I am here today representing the Building Owners and Managers Association International (BOMA). Our membership controls over five (5) billion square feet of U.S. commercial office space. Next week I will be installed as BOMA's president, and I look forward to working with you again in that capacity.

Leasehold improvements, tenant improvements, call them what you will. Commercial real estate, dependent upon rental of office space, retail space, and even industrial space, typically involves lease arrangements with terms ranging anywhere from "month-to-month" to many years. The majority of office leases are in the 5-10 year range, with very large office or retail users getting longer terms or options to renew.

As my colleague from the National Realty Committee has explained, the tax treatment of tenant improvements is flawed. Instead of matching improvement expenses to the life of the improvements, present tax law requires that such expenses be recovered over the life of the whole building. This means that cost recovery of tenant improvements is accomplished on a schedule of thirty-one and one-half (31 1/2) years. (As you know, current tax discussions underway in Congress may extend cost recovery even further -- upwards of thirty-seven (37) years.)

Before the 1981 tax changes, leasehold improvements could be recovered over the useful life of those improvements. After the 1981 Tax Act, cost of improvements had to be recovered over the same depreciation period as the building -- which at that time was fifteen (15) years. The 1986 Tax Act changed all that to establish a depreciation schedule for buildings to thirty-one and one-half (31 1/2) years. Since leasehold improvements were tied to building depreciation, the recovery for those improvements was also extended to thirty-one and one-half (31 1/2) years. If this keeps up, we certainly expect to see that a change in depreciation under any tax bill produced this year, would carry with it a longer depreciation schedule or a longer cost-recovery schedule for tenant improvements. You can begin to see our concern.

In a typical office building, tenant improvements paid for by the owner are undertaken when a tenant signs a lease to occupy space. These improvements range from painting to partitions to interior walls. The "improvements" are what make an office an office.

With the arrival of over 110 new members of Congress this year, a large number of tenant moves and changes took place in House Office Buildings. Because of the configuration of those offices, the age of the buildings, and the interior structure of the office space, "tenant" improvements had more to do with furniture and files than they did with building-out space.

District offices, however, may have required significant alterations to accommodate the incoming Members. Transforming a dentist's office into a Congressional office takes some work. Demolition of some walls and partitions may be necessary. New carpet and fresh paint are typically added, and doorways and office space are configured according to the Representative's needs and budget. In two years, or longer, the space may be altered again. The tenant improvements are not retained for even close to thirty one and one-half years.

If that is the case with a District office of 2000 square feet, imagine the build-out required for a space of 20,000 square feet in the commercial market. With an "allowance" of almost a half-million dollars provided to the tenant for building-out the space, the depreciation issue becomes quite clear.

In the commercial real estate market, office buildings are structured with little more than slabs of concrete, supporting columns, and a central core which includes elevators, bathrooms, and stairwells. When a tenant leases space, it is built out to suit the particular needs of that office operation. We are not talking about crown-molding for the Chairman of the Board. We are talking about special installations for filing and electronic data systems, corporate workstations and centralized production areas. With a real focus on competitiveness in today's global economy, there is increased emphasis on efficiency in operation. Tenant build-outs are specific to the operation - and they change when a new lease is signed.

Every day around this country leases are being signed and new tenants are moving in. Before anyone occupies newly leased space, however, lighting must be installed, office partitions must be built, room dividers, bathroom fixtures, interior partitions, and ceiling tiles all go into making an office an office. With a typical lease ranging from five (5) to ten (10) years and a

depreciation system dramatically flawed, the recovery of expenses for leasehold improvements in no way reflects the useful life of these improvements.

Instead what we find is an unfair tax policy which has shifted as a result of the 1981 and the 1986 tax bills. From a flexible depreciation system that sought to accurately match income with expenses to a system today which dictates recovery of expenses over the soon-to-increase thirty-one and one-half (31 1/2) years, it is clear to see why we believe that the current cost-recovery rules for tenant improvements should be reexamined and modified.

The recovery period for tenant improvements should reflect the useful life of the improvements constructed. One recommendation is to tie the cost-recovery period to the life of the lease term. Depreciation should be tied to the expected life of the "purchase". In the case of tenant improvements, the money spent to build out space for office tenants bears no relation to the value itself. After a useful life, on average ten (10) years, the interior office space will be changed yet again. Unfortunately, the depreciation schedule for the existing workspace will live on another twenty-one and one-half (21 1/2) years.

On behalf of the office building industry across the United States, we ask that this tax treatment of tenant improvements be reexamined and modified.

Thank you.

Mr. PAYNE. Mr. Sheridan.

STATEMENT OF JAMES P. SHERIDAN, MANAGER OF FEDERAL INCOME TAX, KMART CORP., ON BEHALF OF NATIONAL RETAIL FEDERATION

Mr. SHERIDAN. Mr. Chairman, members of the committee, my name is Jim Sheridan, and I am the Federal income tax manager for the Kmart Corp. in Troy, Mich. I am pleased to appear today on behalf of the National Retail Federation to discuss the need for legislation to correct the current harmful tax treatment of leasehold improvements.

As owners and tenants of commercial real estate, we wish to call your attention to a problem that exists under current law that would be exacerbated by a proposal in the Clinton tax plan and the bill recently approved by the House of Representatives, H.R. 2264, which extends the depreciable life of nonresidential real estate from 31½ years to 37 or 39 years, respectively. Current law, President Clinton's proposal, and H.R. 2264 seriously distort the cost recovery for tenant leasehold improvements made to nonresidential real property. This distortion not only affects owners and tenants of the property, but hinders urban renewal, limits construction jobs, and hampers the installation of environmentally friendly building and design elements.

We therefore urge the committee to review this situation and to find a solution that more nearly reflects the economic lives of these improvements. When an owner secures a new tenant for either a new or existing building, the owner must often configure the space to satisfy the needs of the tenant. Prior to the enactment of the accelerated cost recovery system, ACRS, in 1981, the cost of these tenant improvements was divided into its cost components, that is wiring, plumbing, et cetera, and generally depreciated over the individual useful lives. When ACRS, with its artificial 15-year depreciable life for real estate was adopted, it was a reasonable tradeoff to lose component depreciation in exchange for the simplification brought about by lumping all costs into a single 15-year life for the entire property.

Prior to ACRS, the cost of improvements made by a tenant could generally be amortized over the lesser of a lease term or the estimated useful life of the improvements. This rule was retained by the 1981 legislation, leaving tenants with economically viable methods for recovering the cost of tenant leasehold improvements.

In the 1986 act, Congress chose generally to maintain the small number of depreciation classes created by the 1981 act but believed that ACRS should be made more neutral, in part by increasing the recovery period of real property. Congress directed in the 1986 act that class lives must reflect the anticipated useful life, and the anticipated decline in value over time of an asset to the industry or other group. Congress believed that capital investment should be determined by market forces rather than by tax considerations. Thus, the life of nonresidential real property was increased to 31½ years.

At the same time, however, the definition of nonresidential real property was expanded to include leasehold improvements, thereby removing any relationship between cost recovery and the lease

term to which they relate. Leasehold improvements must now be depreciated over the 31½ years in all cases, without respect to the lease term.

The life of a building shell can easily be the 31½ years of current law, or the 37-, 38-, or 39-year life as proposed. The tenant leasehold improvements to that structure, however, will certainly not last for 31½ years, much less 37 or 39 years. It is even unlikely, owing to customer traffic and changing styles, that the tenant leasehold improvements will last even beyond the term of the lease, which itself is typically much less than 31½ years. This result violates all familiar accounting principles and the intent of the 1986 act and does great violence to the rate of return for tenant leasehold improvements.

The economic effect of the current rules upon a tenant can be disastrous. By requiring an artificial 31½-year recovery period for the single largest expenditure a tenant will potentially make during the first year of business, the rules artificially inflate the tax cost beyond economic reality. For many small business tenants, financing is scarce in light of the large tax cost associated with the improvements they must make to begin the business.

Therefore, we urge the committee to review this situation to find the solution to the problem of recovering the costs of tenant leasehold improvements over an economically reasonable period. One solution would be to apply traditional accounting concepts and match the costs of the tenant leasehold improvements against the income from the lease. Short of that result, we would be pleased to work with this committee to craft a solution that more nearly reflects the economic lives of these improvements and the current regime of taxation for depreciable property in general.

We very much appreciate the opportunity to present our views and those of the entire retail industry on this subject and welcome any questions that you might have.

[The prepared statement follows:]

STATEMENT OF JAMES P. SHERIDAN,
MANAGER OF FEDERAL INCOME TAX, KMART CORP.,
ON BEHALF OF THE NATIONAL RETAIL FEDERATION

Mr. Chairman, members of the Committee, my name is James Sheridan, Manager of Federal Income Tax, Kmart Corporation. I am pleased to appear today on behalf of the National Retail Federation to discuss the need for legislation to correct the current harmful tax treatment of leasehold improvements.

By way of background, the National Retail Federation is the nation's largest trade group which speaks for the retail industry. The organization represents the entire spectrum of retailing, including the nation's leading department, chain, discount, specialty and independent stores, several dozen national retail associations and all 50 state retail associations. The Federation's membership represents an industry that encompasses over 1.3 million U.S. retail establishments, employs nearly 20 million people and registered sales in excess of $1.9 trillion in 1992.

The Federation's statement is also endorsed by the Food Marketing Institute, the International Mass Retail Association and the National Association of Chain Drug Stores.

As owners and tenants of commercial real estate, we wish to call your attention to a problem that exists under current law, and would be exacerbated by the proposal in the Clinton tax plan and the bill recently approved by the House of Representatives (H.R. 2264), which extends the depreciable life of nonresidential real estate from 31.5 years to 37 and 39 years, respectively. Current law, President Clinton's proposal, and H.R. 2264 seriously distort the cost recovery for tenant leasehold improvements made to nonresidential real property. This distortion not only affects owners and tenants of the property, but hinders urban renewal, limits construction jobs and hampers the installation of environmentally friendly building and design elements. We therefore urge the Committee to review this situation, and to find a solution that more nearly reflects the economic lives of these improvements.

Background and Current Law

When an owner secures a new tenant for either a new or existing building, the owner often must configure the space to satisfy the needs of the tenant. Prior to the enactment of the accelerated cost recovery system (ACRS) in 1981, the cost of these tenant improvements was divided into its "cost components" (i.e., wiring, plumbing, etc.) and generally depreciated over their individual useful lives. When ACRS, with its artificial 15-year depreciable life for real estate was adopted, it was a reasonable tradeoff to lose component depreciation in exchange for the simplification brought about by lumping all costs into a single 15-year life for the entire property.

Prior to ACRS, the cost of improvements made by a tenant could generally be amortized over the lesser of the lease term or the estimated useful life of the improvements. This rule was retained by the 1981 legislation, leaving tenants with economically viable methods for recovering the cost of tenant leasehold improvements.

In the 1986 Act, Congress chose generally to maintain the small number of depreciation classes created by the 1981 Act, but believed that ACRS should be made more neutral, in part, by increasing the recovery period of real property. Congress directed in the 1986 Act that class lives must reflect the anticipated useful life, and the anticipated decline in value over time, of an asset to the industry or other group. Congress believed that capital investment should be determined by market forces rather than by tax considerations. Thus, the life of non-residential real property was increased to 31.5 years.

At the same time, however, the definition of non-residential real property was expanded to include leasehold improvements, thereby removing any relationship between cost recovery and the lease term to

which they relate. Leasehold improvements must now be depreciated over 31.5 years in all cases, without respect to the lease term.

Reason for Change

The life of a building shell can easily be the 31.5 years of current law, the 37 years of President Clinton's proposal, or even the 39-year life proposed in H.R. 2264. The tenant leasehold improvements to that structure, however, will certainly not last for 31.5 years, much less 37 or 39 years. It is even unlikely that, owing to customer traffic and changing styles, the tenant leasehold improvements will last even beyond the term of the lease, which itself is typically much less than 31.5 years. This result violates all familiar accounting principles and the intent of the 1986 Act, and does great violence to the rate of return for tenant leasehold improvements.

The economic effect of the current rules upon a tenant can be disastrous. By requiring an artificial 31.5 year recovery period for the single largest expenditure a tenant will potentially make during the first year of business, the rules artificially inflate the tax cost beyond economic reality. For many small business tenants, financing is scarce in light of the large tax cost associated with the improvements they must make to begin business.

Requested Action

We urge the Committee to review this situation, and find a solution to the problem of recovering the costs of tenant leasehold improvements over an economically reasonable period. One solution would be to apply traditional accounting concepts and match the costs of the tenant leasehold improvements against the income from the lease. Short of that result, we would be pleased to work with the Committee to craft a solution that more nearly reflects the economic lives of these improvements and the current regime of taxation for depreciable property in general.

We very much appreciate the opportunity to present the views of the retail industry on this subject and we welcome any questions you may have.

Mr. PAYNE. Thank you very much, Mr. Sheridan.

Do we have questions of any of the members? I would like, then, to thank all of you for your testimony today. I think it was very thoughtful, comprehensive, and a very necessary part of continuing the legislative process, and we thank you for your time and thank you for your testimony. Thank you very much.

We now have our sixth and final panel for today's hearing: from the General Motors Corp., Mustafa Mohatarem, general director of economics; from the Semiconductor Industries Association, Cliff Jernigan, chairman of the tax subcommittee; Computer Leasing & Remarketing Association, Ken Bouldin, who is the immediate past president; and the Kaman Corp. from Bloomfield, Conn., Glenn Messemer, who is vice president, secretary, and general counsel.

All of your statements will be entered into the record. There will be a timing system, and if you can confine your summary remarks to about 3 minutes, we would appreciate that very much, and Mr. Mohatarem, I hope I have said that right, will you proceed, please.

STATEMENT OF G. MUSTAFA MOHATAREM, GENERAL DIRECTOR OF ECONOMICS, GENERAL MOTORS CORP.

Mr. MOHATAREM. Thank you, Mr. Chairman and members of the committee. My name is Mustafa Mohatarem. I am general director of economics for General Motors Corp. I appreciate the opportunity to be here to discuss a technical issue that has important economic implications for small firms that purchase motor vehicles for use in their businesses as well as for the domestic automobile industry.

The issue is first-year expensing for passenger cars and trucks acquired for use by small businesses. We appreciate Congressman McCrery's strong interest in this important issue and his request for inclusion of this issue in these hearings. Internal Revenue Code section 179 currently allows small businesses to expense up to $10,000 of the cost of most depreciable assets in the year of acquisition. The House has proposed that this limit be raised to $25,000. The stated purpose of this is to provide an incentive to small businesses to increase their investments, thus promoting economic growth and increasing demand for productive assets.

General Motors believes that this desired stimulative effect will be substantially reduced by existing limits on the cost recovery of motor vehicles. Specifically, section 280F of the code, the so-called luxury automobile depreciation rules, restricts the writeoff of most motor vehicles to less than $3,000 for the first year and to approximately $13,000 over the vehicle's 5-year depreciation recovery period. The effect is to deny most small business purchasers of motor vehicles any incremental tax benefit from section 179 expensing. Many of the smallest firms intended to be helped by increased expensing, such as the local carpenter, grocer, florist or farmer may receive no benefit from the proposed increase in the limit to $25,000 because a delivery van or pickup truck may be the only significant depreciable asset purchased during a year.

The current rules thus discriminate against small firms who invest in business use vehicles as compared to small firms who make nonautomotive purchases. A simple and equitable solution would be to allow for expensing of motor vehicles up to the 5-year luxury depreciation limit, currently just under $13,000, assuming Con-

gress raises the $10,000 threshold. This would reduce the discrimination against small firms that invest in business use vehicles during a tax year without changing the luxury depreciation limits.

Whether or not a motor vehicle qualifies for first year expensing has important cash flow implications for small firms. Qualifying for expense treatment would lower the present value for a vehicle's aftertax purchase cost by 3 to 10 percent, depending on the price of the vehicle. Given the average transaction price of roughly $17,800, this would translate into aftertax cost reduction of 9 percent. Using our conventional models that we use in all regulatory proceedings in the industry, that would suggest a 9 percent increase in purchases by the affected businesses.

Importantly, because approximately 95 percent of the business use vehicles are purchased from domestic manufacturers, the beneficiaries would be the domestic auto industry, thereby leading to higher U.S. employment. While it is difficult to estimate the precise number of small businesses that would be affected by this change, we believe the change would provide many small businesses with an important cash flow incentive to purchase vehicles. While we can't estimate the precise number, we believe that it is significant and it is an important customer group for General Motors.

Before I close, I might add that this is only one example of discrimination against the purchasers of automobiles. For instance, the so-called luxury depreciation cap that I have just cited, which is approximately $13,000, compares to an average transaction price of around $18,000 for a vehicle, so it is by no means a luxury cap. We hope that the Congress will be able to address inequities such as these in the future.

In closing, General Motors urges the committee to consider extending the benefits of section 179 to purchasers of business use motor vehicles at least to the extent of the 5-year luxury depreciation limitation. We offer any assistance we can provide to you and your staff in reviewing this technical issue. Thank you again for your consideration.

Mr. PAYNE. Thank you very much, Mr. Mohatarem.

[The prepared statement follows:]

Statement of General Motors Corporation
Submitted to the
Subcommittee on Select Revenue Measures, Committee on Ways and Means
U.S. House of Representatives
Presented by
G. Mustafa Mohatarem, General Director, Economics
June 17, 1993, Washington D.C.

Good morning. My name is Mustafa Mohatarem. I am General Director of Economics for General Motors Corporation. I appreciate the opportunity to be here today to discuss a technical issue that has important economic implications for countless small firms that purchase motor vehicles for use in their businesses, as well as for the domestic automobile industry. The issue is first-year expensing for passenger cars and trucks acquired for use by small businesses.

Internal Revenue Code section 179 allows small businesses to expense up to $10,000 of the cost of most depreciable assets in the year of acquisition. The House has proposed in its reconciliation bill that this expensing limit be raised to $25,000. The stated purpose of this proposal is to provide an incentive to small businesses to increase their investment in capital assets, thus promoting economic growth and increasing demand for productive assets.

General Motors believes that this desired stimulative effect of the proposed increase in the small business expensing limit will be substantially reduced by existing limits on the cost recovery of motor vehicles. Specifically, section 280F of the Code, the so-called luxury automobile depreciation rules, restricts the write-off for most motor vehicles to less than $3,000 for the first year, and to approximately $13,000 over the vehicle's five-year depreciation recovery period. The first-year limitation of about $3,000 applies to the sum of the depreciation deduction and the small business expensing deduction under section 179. The effect is to deny most small business purchasers of motor vehicles any incremental tax benefit from section 179 expensing. Many of the smallest firms intended to be helped by increased expensing, such as the local carpenter, grocer, florist, or farmer, may receive no benefit from the proposed increase in the limit to $25,000 because a delivery van or pick-up truck may be the only significant depreciable asset purchased during a year.

The current rules, thus, discriminate against small firms who invest in business-use vehicles as compared to small firms who make non-automotive investments. A simple and equitable solution would be to allow for expensing of motor vehicles up to the five-year luxury depreciation limit, currently just under $13,000, assuming Congress raises the $10,000 threshold. This would reduce the discrimination against small firms that invest in business-use vehicles during a tax year, without changing the luxury depreciation limits. In other words, small businesses purchasing cars or trucks should be allowed to benefit from enhanced expensing rules at least to the extent of the non-luxury content of purchased vehicles. This would place all small businesses on more equitable footing, whether they invest in motor vehicles or in non-automotive business assets. We believe such improved neutrality is essential to effective, efficient and equitable tax law.

Whether or not a motor vehicle qualifies for additional first-year expensing has important cash flow implications for small firms. This is because qualifying for expense treatment would lower the present value of a vehicle's after-tax purchase cost by 3%-10%, depending on the price of a vehicle. For example, the after-tax cost of an average priced vehicle --$17,800-- would be reduced by approximately nine percent.

The purchasers of motor vehicles, especially small businesses, are very responsive to price changes. It is estimated that a 3%-10% price decrease could bring about a 3%-10% increase in vehicle purchases by affected small businesses.

Approximately 95% of business-use vehicles on the road were made by domestic manufacturers. Increased vehicle sales would, thus, principally benefit the domestic automobile industry, thereby increasing U.S. employment levels in the domestic motor vehicle industry and its suppliers.

It is very difficult to estimate the precise number of small businesses that would be affected by this change, that is, the number of small firms purchasing only automotive assets during a tax year. We believe, though, that the change would provide many small businesses with an important cash flow incentive to purchase vehicles. Moreover, many of these businesses are so small that they are unlikely to be represented here. Nonetheless, they constitute an important customer group for General Motors and the other domestic manufacturers.

Before I close, I might add that the limitation on small business expensing is only one of a number of provisions in the Code that discriminate against purchasers of automobiles. For example, under the House-passed bill, automobiles would be the only product still subject to a luxury tax. The so-called luxury depreciation cap cited above, which is approximately $13,000 as compared to the average vehicle price of about $17,800, is another example, as is the five-year class life, when three years more appropriately reflects economic life according to a 1991 Treasury study. We hope that Congress will address these inequities at a later date.

In closing, General Motors urges the Committee on Ways and Means to consider extending the benefits of section 179 expensing to purchasers of business-use motor vehicles at least to the extent of the five-year luxury depreciation limitation. We offer any assistance we can provide to you and your staff in reviewing this technical issue. Thank you for your consideration. I would be happy to answer any questions that you may have at this time.

Mr. PAYNE. Mr. Jernigan.

STATEMENT OF CLIFF JERNIGAN, CHAIRMAN, TAX SUBCOMMITTEE, PUBLIC POLICY COMMITTEE, SEMICONDUCTOR INDUSTRY ASSOCIATION, AND DIRECTOR, GOVERNMENT AFFAIRS, ADVANCED MICRO DEVICES

Mr. JERNIGAN. Mr. Chairman, members of the committee, the Semiconductor Industry Association is pleased to have the opportunity to testify before you about a depreciation issue of vital importance to the U.S. semiconductor industry. My name is Cliff Jernigan. I am the director of government affairs for Advanced Micro Devices and chairman of the Tax Subcommittee of SIA's Public Policy Committee.

The SIA is comprised of U.S.-based semiconductor manufacturers. Its member companies account for 85 percent of U.S. semiconductor production and employ over 250,000 Americans. The SIA was created in 1977 to address public policy issues confronting the industry. SIA concentrates its energies on those issues which affect the ability of the industry to remain internationally competitive. Semiconductors, which account for about $60 billion in worldwide sales, are the heart of the electronics industry which employs over 2.3 million Americans. They are the crude oil of the information age, with applications in computers, telecommunications, instruments, automobiles, and defense.

Members of the SIA are adversely impacted by the current law 5-year depreciable life of semiconductor manufacturing equipment. This rate does not reflect the true economic life of the equipment and should be changed to 3 years for a number of reasons. In my testimony I would like to explain the SIA's position on the administration's tax proposal as well as give reasons for supporting 3-year depreciation of semiconductor manufacturing equipment.

The 3-year depreciation issue was first recommended by the National Advisory Committee on Semiconductors, also called NACS, a blue ribbon Government-industry panel established by Congress in the 1988 Trade Act to develop a national semiconductor strategy. The NACS concluded that a change in the depreciable life of semiconductor manufacturing equipment is the most effective way to boost semiconductor capital spending.

Changing the depreciable lives would boost U.S. semiconductor industry investment by 11 percent, according to the NACS. The NACS also concluded that in the absence of changes in U.S. capital formation policies, Japan will gain market share in this critical industry. The relative competitiveness of semiconductor firms is dependent upon their ability to sustain a high level of capital investment in new plant and equipment. The industry is characterized by a very high rate of technological obsolescence with new process technologies and new generations of devices being developed every 3 to 3½ years.

To remain at the state of the art in semiconductor technology and be competitive, the U.S. semiconductor industry must have access to patient, affordable capital. For example, in 1991 SIA members invested an average over the last 12 years of 12 percent of sales in R&D and 14 percent of sales in capital expenditures. These are among the highest investment rates of any domestic industry.

In fact, we are unaware of any industry that invests more in capital as a percentage of sales.

Economic studies conclude that semiconductor manufacturing equipment should be entitled to a 3-year depreciable life. The economic life of the equipment is 3.75 years, entitling it to 3-year depreciation under the current statutory framework. The change would not provide any special treatment to the semiconductor industry. It would simply correct the tax law to accurately reflect the rapid pace of technological obsolescence in the industry's equipment. This is exactly the sort of reform which candidate Clinton called for in his technology statement which promised to immediately ensure that depreciation schedules reflect the rapid rate of technological obsolescence of today's high-tech equipment.

The change in depreciable life would help offset the tax advantages enjoyed by America's foreign competitors. For example, our major competitor, Japan, allows semiconductor companies to write off more than 88 percent of the cost of their semiconductor manufacturing equipment in the first year. U.S. companies can write off only 20 percent of their first-year investment.

Finally, despite the President's campaign pledge to stimulate growth in high-technology industries and to increase capital investment by domestic industries, the administration's tax proposals and those in the House budget reconciliation bill do not help the semiconductor industry. Most semiconductor companies will be unable to use the R&E credit due to the base period calculation despite the fact that the industry spends about 12 percent of its sales each year on R&E activities. The alternative minimum tax, or AMT, reform proposal would have little positive effect on the industry because the depreciable life of semiconductor manufacturing equipment is 5 years for both regular tax and AMT purposes. Other industries could substantially benefit from the proposal. The tobacco industry would see the depreciable life of its assets shortened from 15 to 7 years and the lives of pharmaceutical and chemistry industry assets would be reduced from 9½ to 5 years. By changing the depreciable life of semiconductor manufacturing equipment, U.S. semiconductor industry investment would be stimulated and the goal of the administration to emphasize the role of Government in preserving America's high-technology industry would be accomplished. SIA is deeply committed to changing the depreciable life of semiconductor manufacturing equipment from 5 years to 3 years in order to enhance our capital formation. Thank you very much.

Mr. PAYNE. Thank you very much, Mr. Jernigan.

[The prepared statement follows:]

STATEMENT OF CLIFF JERNIGAN,
DIRECTOR, GOVERNMENT AFFAIRS ADVANCED MICRO DEVICES
ON BEHALF OF THE SEMICONDUCTOR INDUSTRY ASSOCIATION

INTRODUCTION

The Semiconductor Industry Association (SIA) is pleased to have the opportunity to testify before this subcommittee about an issue of vital concern to the U.S. semiconductor industry -- the depreciable life of semiconductor manufacturing equipment. My name is Cliff Jernigan. I am the Director of Government Affairs for Advanced Micro Devices and Chairman of the Tax Subcommittee of SIA's Public Policy Committee.

The SIA is comprised of U.S.-based semiconductor manufacturers. Its member companies account for 85 percent of U.S. semiconductor production and employ over 250,000 Americans. The SIA was created in 1977 to address the public policy issues confronting the industry. SIA concentrates its energies on those issues which affect the ability of the industry to remain internationally competitive.

Members of the SIA are greatly impacted by the current law five year depreciable life of semiconductor manufacturing equipment. This rate does not reflect the true economic life of the equipment and adversely affects our competitiveness. While U.S. law allows only a 20 percent depreciation deduction for semiconductor manufacturing equipment in the first year, our primary competitors, the Japanese, can write off up to 88 percent of the cost of equipment in the first year.

Despite the President's campaign pledge to stimulate growth in high-technology industries and to increase capital investment by domestic industries, pending tax proposals do not help the U.S. semiconductor industry. SIA urges Congress and the Administration to develop additional means of encouraging capital investment in semiconductors by endorsing the proposed change in the depreciable life of semiconductor manufacturing equipment from five years to three years for both regular and alternative minimum tax (AMT) purposes.

BACKGROUND

A vibrant, world-class semiconductor industry is universally acknowledged to be vital to America's national security and economic well-being. Semiconductors are the "crude oil" of the information age -- driving technological advances in industries such as computers, telecommunications, and consumer electronics. Semiconductor technology is at the heart of a $750 billion global electronics industry that employs 2.3 million Americans, and is growing at roughly 10 percent per year. Semiconductors are also essential for defense capabilities such as electronic counter-measures, target recognition and C3I (command, control, communications and intelligence), and play an important role in 18 of the 21 defense-critical technologies identified by the Department of Defense.1.

The pace of technological change in the semiconductor industry is astounding. The number of transistors on a computer chip has increased from 10 in the early 1960's to 10 million today. By the year 2000, the U.S. industry hopes to place over 10 billion transistors on a single chip. Such a chip could store the equivalent of a 20-volume encyclopedia, or provide all of the computing power of one of today's leading-edge supercomputers.

Although this technology was invented in the United States, the position of the U.S. industry eroded steadily during the 1980's. From 1982 to 1990, the U.S. industry's share of the world market declined from 56.7 percent to 39.8 percent, while Japan's share rose from 32.5 percent to 47.1 percent. Although the United States achieved parity in worldwide market share with the Japanese in 1992, this achievement is tenuous and further investment is necessary to maintain and improve our position. The earlier decline in market-share occurred for a number of reasons:

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1. See Department of Defense, *Critical Technologies Plan*, (Washington, D.C: May 1991), and National Critical Technologies Panel, *Report of the National Critical Technologies Panel*, (Washington, D.C.: March 1991).

- The U.S. lost many industries which use semiconductors, such as the consumer electronics industry.

- The U.S. industry had been injured by unfair trading practices, such as illegal "dumping" of their products in the U.S. market and denial of foreign market access. Japanese dumping of DRAMs in the mid-1980s, for example, forced 6 out of 8 U.S. DRAM manufacturers out of the market.

- Other governments have made the development of a semiconductor industry a national priority, and have "targeted" the industry by funding R&D consortia, extending low-interest loans, and providing favorable tax depreciation treatment and other tax incentives.

- Our primary competitors, the Japanese, for example, allow up to 88 percent of the original acquisition cost of semiconductor equipment to be written off in the first year compared to 20 percent by U.S. firms.2.

- Between 1984 and 1989, Japanese firms outinvested U.S. firms in plant and equipment and R&D by $12 billion.

The competition between U.S. and Japanese capital spending is particularly important, since there is a high correlation between investment and market share. The difference in depreciation rates between the United States and Japan impacts U.S. capital spending and thus market share and technological leadership, with devastating consequences for America's economic well-being and national security.

The National Advisory Committee on Semiconductors (NACS), a presidential-appointed commission composed of Cabinet officials and senior industry executives, has identified the gap in capital spending as one of the most serious problems facing the industry. The NACS reviewed several different tax policy instruments: a reduction in the capital gains tax rate, a more effective R&E tax credit, increases in personal savings incentives, and an improvement in semiconductor manufacturing equipment depreciation rules. The committee found that shortening the depreciable life of semiconductor manufacturing equipment would have the most significant impact on increasing capital investment. Shortening the depreciation schedule from the current five years to three years would increase investment by the semiconductor industry by 11 percent, according to the NACS. This would significantly reduce, although not eliminate, the gap between U.S. and Japanese capital spending.3.

The Semiconductor Industry Association strongly supports the conclusions and recommendations of the National Advisory Committee on Semiconductors. Other changes in tax policy designed to enhance U.S. capital formation (e.g. investment tax credit, capital gains tax reduction, increased incentives for personal savings, improvements in the R&E tax credit) should also be considered. However, as discussed below, the Administration's recent proposals in these areas do not benefit U.S. semiconductor producers. It is clear from the NACS study and SIA's analysis of the Administration's proposals, that a change in the depreciation rules for semiconductor manufacturing equipment will have a more dramatic impact than the other tax proposals currently under consideration. For a number of reasons, SIA believes that the case for improving semiconductor manufacturing equipment from five to three years is clear and compelling.

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2. Technecon Analytical Research, Inc., *Analysis of the Relative Economic Benefits of Tax Depreciation Policies for Semiconductor Equipment and Facilities in the United States and Japan*, 1991.

3. National Advisory Committee on Semiconductors, *Capital Investment in Semiconductors: The Lifeblood of U.S. Semiconductor Industry*, Washington, D.C., September 1990.

1. The Clinton Administration has continually expressed their support for high-technology industries; however, the actual tax proposals do little or nothing to benefit the U.S. semiconductor industry: President Clinton strongly emphasized the role of government in preserving America's high-technology industry in his campaign. The President has also proposed, as part of his economic agenda, a permanent research and experimentation (R&E) credit and alternative minimum tax (AMT) depreciation reform. Unfortunately, these initiatives, which are also in the House budget reconciliation bill, generally would not improve the competitive position of the U.S. semiconductor industry or increase capital investment by the industry. The previously considered temporary investment tax credit would have also provided little, if any, benefit to the industry. Moreover, the proposals to eliminate deferral of U.S. tax on certain foreign subsidiary manufacturing income and revise the treatment of foreign royalty income would damage the international competitiveness of the industry.

Many semiconductor firms will receive little benefit from the proposed R&E credit. The R&E credit would be limited to R&E spending above a threshold level that is based on the ratio of R&E spending to sales during the 1984-1988 "base period." During this period, however, many high-tech companies maintained their R&E investments despite declines in sales due to Japanese companies illegally "dumping" their products in the United States. Thus, the R&E to sales ratio threshold for these companies is disproportionately high. Because only R&E spending above this threshold would be eligible for the credit, many high-tech companies would be unable to use most or all of the credit despite the high level of R&E activity (about 12 percent of sales each year) by the industry.

The AMT depreciation reform proposal also would do little for the U.S. semiconductor industry. For example, making AMT depreciable lives the same as regular tax depreciable lives would provide quicker AMT depreciation to certain industries, but not the semiconductor industry. Under current law, the depreciable life of semiconductor manufacturing equipment is five years for both regular tax and AMT purposes even though the true economic life of semiconductor manufacturing equipment should entitle it to three year depreciation. Unless the tax law is changed to allow three year depreciation for semiconductor manufacturing equipment, the Administration's proposal to make AMT depreciable lives the same as regular tax depreciable lives would not be beneficial.

The U.S. semiconductor industry would be adversely impacted by the proposed elimination of deferral of U.S. tax on certain foreign subsidiary manufacturing income. Under this proposal, our foreign competitors, who benefit from generous tax deferral regimes and tax-sparing treaties that allow them to repatriate low-taxed earnings without additional tax, would have a serious competitive advantage over U.S. firms. Our foreign competitors would also have an advantage if the revised foreign royalty income proposal, which was dropped by the House, is resurrected. Treating this income as earned from passive sources would be detrimental to the competitiveness of this industry.

Since the three key tax incentive provisions in the House bill do not address the needs of the U.S. semiconductor industry, it is vital for the economic health of this industry as well as the economic and national security of the country that an additional means of encouraging capital investment in semiconductor manufacturing be enacted. SIA urges the Committee to support three-year depreciation of semiconductor manufacturing equipment.

2. The technological life of semiconductor manufacturing equipment is shorter than five years: A recent economic study by American Appraisal Associates showed that the economic life of semiconductor manufacturing equipment was 3.75 years allowing the equipment to be treated as "3 year property" for purposes of the current law general tax depreciation rules.4. Furthermore, because new generations of semiconductors are introduced every three to three and one-half years, equipment rapidly becomes technologically obsolete because more advanced types of equipment are required for volume

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4. American Appraisal Associates, *Depreciation Rates Report for Semiconductor Manufacturing Equipment,* January, 1992.

production of state-of-the-art integrated circuits. This suggests that a change in depreciation policy is necessary if the United States wishes to maintain a world-class semiconductor industry.

3. Faster depreciation is necessary to offset the tax advantages of America's competition: Japanese electronics companies enjoy a wide range of tax incentives for investment in semiconductor plant and equipment and R&D. In Japan, depreciation for semiconductor manufacturing equipment is much more generous than what the U.S. allows. Japanese firms qualify for accelerated depreciation if the equipment is operated more than eight hours per day -- a significant advantage given that most wafer fabrication facilities operate twenty four hours per day. Additional significant tax incentives are provided to companies that locate in certain geographical areas. As a result of these incentives, Japanese companies can write off up to 88 percent of their investment in new equipment in the first year, whereas U.S. companies can write off only 20 percent.

Japanese firms also enjoy other tax incentives. Equipment purchased for use in a joint R&D venture can be written off in one year. The Key Technologies Credit targets 132 highly specific technologies, many of which are semiconductor-related, such as Class 100 (or better) clean rooms, semiconductor material purity thermal testers, ion implantation devices, and laser chemical vapor deposition systems.5.

4. Faster depreciation will continue to strengthen the U.S. semiconductor manufacturing equipment industry: The U.S. position in semiconductor equipment was also eroding rapidly in the 1980's. In 1980, all of the top ten semiconductor equipment manufacturers were U.S. companies; by 1989, four of the top five producers were Japanese. Although U.S. firms are regaining market share, there is much room for improvement. The SIA is committed to ensuring that there is at least one U.S. supplier for each type of semiconductor manufacturing equipment. Faster depreciation would increase U.S. capital spending by at least 11 percent, which would stimulate demand for semiconductor manufacturing equipment and strengthen the U.S. semiconductor manufacturing industry.

5. The national security and economic well-being of the United States is dependent upon a strong, domestic semiconductor industry: Semiconductors are the "crude oil" of the information age and vital to computers, telecommunications, instruments, automobiles and defense. Without a domestic semiconductor industry, the United States would be required to use solely foreign sources to supply its military and commercial needs. Advances in our weaponry would be dependent upon state-of-the-art technology coming from other countries. The U.S. electronics industry, which employs more Americans than the U.S. automotive, steel and aerospace industries combined, would be at risk.

6. Tax policy is particularly important because the industry is characterized by rising capital costs and prices which fall rapidly after introduction: In 1992, the U.S. semiconductor industry devoted 14 percent of sales per year to capital spending and another 12 percent of sales to R&D. The cost of a state-of-the-art wafer fabrication facility is currently **$500 million to $1 billion**, and is increasing by a factor of 2.5 times every 6 years, while prices for semiconductor products drop sharply soon after they are introduced. From 1978 to 1989, the price per bit for DRAMs has decreased at a compound annual rate of 26

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5. The credit amount is equal to the lesser of (a) seven percent of the acquisition (or qualified lease) cost of assets used in the development of these technologies, or (b) 15 percent of the corporate income with a one year carry forward. Companies are eligible for the Key Technologies Credit even if R&D expenses during the year are not increased. See *Haiteku zeisei no kaisetsu* (Explanation of the High Tech Tax System), Technology Promotion Deportment, Agency for Industrial Science and Technology, Ministry of International Trade and Industry, 1990, as cited in John P. Stern, *Technotax: How Far Japan's Tax System Spurs Technology*.

percent.6. This means that the window in which firms can hope to recover their investments is extremely small.

CONCLUSION

The United States must adopt capital formation policies which reflect the economics of the semiconductor industry and the realities of international competition. This correction in the depreciation rules for semiconductor manufacturing equipment will help strengthen two strategic sectors -- the semiconductor industry and the semiconductor manufacturing equipment industry. It will reduce the growing gap between U.S. and Japanese capital spending in semiconductors, which is attributable in part to a wide range of the benefits that the Japanese government extends to their industry. If the United States fails to take this step, the U.S. industry will be hard-pressed to make the large investments necessary to stay at the cutting-edge of technology. Microelectronics technology has had an enormous and pervasive impact on our quality of life and on the productivity of new and existing industries, and there is every reason to believe that the pace of technological change will continue. The Administration has expressed a true commitment to promoting U.S. high-technology industries. The Administration and Congress can accomplish this by strengthening capital formation in the U.S. semiconductor industry.

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6. From 1978 to 1989, the price per bit for DRAMs decreased by a factor of 37.8; from 48.39 millicents per bit to 1.28 millicents per bit.

Mr. PAYNE. Mr. Bouldin.

STATEMENT OF KENNETH A. BOULDIN, IMMEDIATE PAST PRESIDENT, CDLA, COMPUTER LEASING & REMARKETING ASSOCIATION

Mr. BOULDIN. Mr. Chairman, I am Kenneth Bouldin, and I appear today as the immediate past president of CDLA, the Computer Leasing & Remarketing Association. CDLA represents more than 300 computer leasing and remarketing companies which account for the majority of computer equipment leased in the United States.

In summary, Mr. Chairman, due to technological obsolescence, computers lose economic value very rapidly. This is supported by a 1990 study by the Gartner Group, a Dun & Bradstreet subsidiary. However, the alternative minimum tax depreciation allowance fails to reflect this economic fact, and as a result, computer owners and users are effectively taxed on their capital. In other words, the depreciation allowed for computers under the regular tax is not accelerated relative to economic depreciation and therefore should not be treated as a preference under the AMT.

This year Congressman Andrews introduced H.R. 1956, which would provide 200 percent declining balance depreciation for computers under the AMT. We applaud his sponsorship and strongly support his bill.

In contrast, to our grave disappointment, the administration's proposals concerning depreciation under the AMT, which were recently approved by the House, essentially provide no relief for computers. This is particularly ironic given the administration's commitment to encourage U.S. high technology. Although the current administration proposal would dedicate approximately $9 billion to AMT relief, virtually none of it would go towards fair AMT depreciation for computers. It is therefore with a sense of great urgency that I testify today.

Virtually all agree that computers and other high-technology equipment are critical to America's economic future. Despite this recognition, however, the tax depreciation rules governing computers are long outdated, unfair, and actually discourage investment in computers. Depreciation of computers has remained largely unchanged since they were first recognized as a separate class of depreciable assets in 1973, and not surprisingly fails to reflect the computer revolution.

The appended study by the Gartner Group concludes that in 1990, when the study was conducted, computers were losing their economic value at a declining balance rate of 210 percent. Moreover, because of the quickening pace of innovation and the increasing preference for smaller computers, which tend to lose value fastest, the 1990 Gartner Group report almost certainly overstates the economic life of most computers placed in service today. Thus the Tax Code not only fails to encourage the acquisition of computers, it discourages U.S. businesses from making the necessary investment in newer computer technology and decreases demand for U.S.-made computer products, both of which are central to our economic growth.

The administration's proposal to liberalize the AMT contained in the House version of the pending reconciliation bill would increase the rate of recovery to the 120 percent declining balance rate. As a result, taxpayers would recover 33.1 percent of their cost for computers in the first 2 years as opposed to 32.6 percent under the current law. Needless to say, the improvement is nominal at best.

The administration's proposal would also make all AMT recovery periods consistent with the recovery periods currently effective for regular tax purposes. Although this would benefit many assets, computer owners and users would gain nothing from the change because computers are presently depreciated over 5 years for both the regular tax and the AMT.

It is noteworthy that the AMT reform package contained in last year's vetoed tax bills which would have increased the rate of depreciation to 150 percent declining balance, was significantly more appropriate for computers than the administration's proposal.

I understand that the Senate Finance Committee Democrats agreed yesterday to include the AMT reforms from last year in the committee's recommendation to the Budget Committee to be incorporated in the reconciliation bill. That change is a substantial improvement over the House bill but nevertheless leaves intact the current tax disincentive to invest in computers.

It is also important to recognize that our major economic competitors permit depreciation of computers in line with the conclusions of the Gartner Group report. England, Japan, and Germany currently provide for the recovery of 55.0, 53.6, and 51.0 percent of computer costs, respectively, in the first 2 years of ownership, compared to only 33.1 percent under the administration's proposal.

If we are to make the necessary investments in computer technology to compete and to succeed in the global marketplace, our tax laws cannot continue to discourage such investments. Accordingly, CDLA urges the adoption of AMT depreciation for computers at a 200 percent declining balance rate over 5 years. This would be substantially more consistent with economic reality and our national policy objectives and would still be more conservative than the Gartner Group's findings.

I would be happy to answer any questions. We appreciate the opportunity to testify.

Mr. PAYNE. Thank you very much, Mr. Bouldin.

[The prepared statement follows:]

CDLA
The Computer Leasing &
Remarketing Association

Statement of Kenneth A. Bouldin
on Behalf of CDLA, the Computer Leasing and
Remarketing Association

Before the Subcommittee on Select Revenue Measures,
of the Committee on Ways and Means
Regarding Miscellaneous Revenue Issues

June 17, 1993

My name is Kenneth A. Bouldin. I appear today as the immediate past President of CDLA, the Computer Leasing and Remarketing Association, which represents more than 300 computer leasing and remarketing companies which account for the majority of computer equipment leased in the United States. I appear today on behalf of CDLA, but I am also responsible for the Federal Marketing Group of Comdisco, Inc., the world's largest independent lessor and remarketer of computer equipment and a CDLA member. Accompanying me today is Jerry Oppenheimer of Mayer, Brown & Platt.

Simply put, due to technological obsolescence, computers lose economic value very rapidly. This is supported by a 1990 study by the Gartner Group, a Dun & Bradstreet subsidiary.[1] However, the alternative minimum tax ("AMT") depreciation allowed for computers fails to reflect this economic fact. Thus, computer owners and users are effectively taxed on their capital. In other words, the depreciation allowed for computers under the regular tax is not accelerated relative to economic depreciation and therefore should not be treated as a "preference" under the AMT.

CDLA and its members have been working for several years to obtain fairer and more appropriate AMT depreciation for computers. As a result of those efforts, in 1990, all but three of the then Members of the Ways and Means Committee cosponsored a bill (H.R. 5376) that would have provided fairer depreciation for computers. This year, Congressman Andrews introduced H.R. 1956, which would provide 200 percent declining balance depreciation for computers under the AMT. We applaud his sponsorship and strongly support his bill.

In contrast, to our grave disappointment, the Administration's proposals concerning depreciation under the AMT, which were recently approved by the House (section 12115 of H.R. 2264), essentially provide no relief for computers. This is particularly ironic given the Administration's commitment to encourage U.S. high-technology. Although the current Administration proposal would dedicate approximately $9 billion to AMT relief, virtually none of it would go toward fairer AMT depreciation for computers. It is, therefore, with a sense of great urgency that I testify today.

The Need for More Appropriate AMT Depreciation Allowances

Virtually all agree that computers and other high technology equipment are critical to America's economic future. The Clinton Administration's technology policy statement concludes that "[t]echnology is the engine of economic growth" and the key to creating a vital, high-wage economy.[2]

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[1] The study was conducted in accordance with methods explicitly approved by Congress in the Tax Reform Act of 1986.

[2] See Technology for America's Economic Growth, A New Direction to Build Economic Strength, p. 7 (2/22/93). The Office of Technology Assessment has similarly concluded that "technology is the key to competitive success." See Making Things Better:

1212 Potomac Street, NW
Washington, DC 20007
202 333 0102
FAX 202 333 0180

Despite this recognition, the tax depreciation rules governing computers are long outdated, unfair, and actually discourage investment in computers.

Under current AMT depreciation rules, businesses are permitted to recover their investment in computers over five years. The 150-percent declining balance rate of depreciation is used for regular AMT purposes, but the straight line method is used for purposes of making the adjusted current earnings ("ACE") AMT adjustment.

Depreciation of computers has remained largely unchanged since they were first recognized as a separate class of depreciable assets in 1973[1] and, not surprisingly, fails to reflect the "computer revolution." A study by the Gartner Group, attached for the record, concludes that by 1990, when the study was conducted, computers were losing their economic value at a declining balance rate of 210 percent (assuming a five-year recovery period). Moreover, because of the quickening pace of innovation and the increasing preference for smaller computers, which tend to lose value fastest, the 1990 Gartner Group report almost certainly overstates the economic life of most computers placed in service today. Thus, computers lose their economic value much faster than AMT taxpayers are permitted to depreciate them.

As a result, the tax code not only fails to encourage the acquisition of computers, it effectively taxes capital invested in, rather than income generated by, computers. This discourages U.S. businesses from making the necessary investments in newer computer technology and decreases demand for U.S. made computer products, both of which are central to our economic growth.

The Administration's proposal to liberalize the AMT rules, contained in the House version of the pending Reconciliation bill (section 14115 of H.R. 2264), would eliminate the ACE adjustment and change the rate of recovery to the 120 declining balance rate. As a result, taxpayers would recover 33.1 percent of their computer costs in the first two years (as opposed to 32.6 percent under current law). Needless to say, that improvement is nominal at best.

The Administration's proposal would also make all AMT recovery periods consistent with the recovery periods currently effective for regular tax purposes. Although this would benefit many classes of assets, computers owners and users would gain nothing from the change because computers are presently depreciated over five years for both the regular tax and the AMT. In other words, the Administration proposes to spend approximately $9 billion on AMT reform over the next five years, but virtually none of that amount on reforming depreciation of computers.

Competing in Manufacturing, p.1 (OTA-ITE-444, February 1990).

[1] See Rev. Proc. 73-2, 1973-1 C.B. 747 (adopting six-year asset guideline period for "information systems"). Prior to 1973, computers were not explicitly described in the depreciation tables, but would have fallen under the general category of "office furniture, fixtures, machines, and equipment", all of which were depreciable over ten years. See id. at 747. In 1981, computers became five-year property under the then newly enacted accelerated cost recovery system and their recovery period has not changed since.

It is noteworthy that the AMT reform package contained in last year's vetoed tax bills (H.R. 4210 and H.R. 11), which would have increased the rate of depreciation to 150 percent declining balance (but left the AMT recovery periods unchanged), was significantly more appropriate for computers than the current Administration proposal.

It is also important to recognize that our major economic competitors permit depreciation of computers in line with the conclusions of the Gartner Group report. England, Japan, and Germany currently provide for the recovery of 55.0, 53.6, and 51.0 of computer costs, respectively, in the first two years of ownership.[4/] This compares with only 32.6 percent under the current AMT rules and 33.1 percent under the Administration's proposal.

If we are to make the necessary investments in computer technology to compete and succeed in the global marketplace, our tax laws cannot continue to discourage such investments. Accordingly, CDLA urges the adoption of AMT depreciation for computers at a 200 percent declining balance rate over five years (identical to the current normal tax treatment). This would be substantially more consistent with economic reality and our national policy objectives and would still be more conservative than the Gartner Group's findings.[5/]

I would be happy to answer any questions.

[4/] See Ways and Means Committee of the House of Representatives Hearings on U.S. International Competitiveness, July 17, 1991 (statement of Stephen M. Chaleff on behalf of CDLA) (comparison of depreciation allowances prepared by Arthur Andersen & Company).

[5/] The proposal is also consistent with the permanent extension of the research and experimentation credit, as passed by the House, which would encourage the pace of technological progress (and obsolescence) for computers and other equipment.

Mr. PAYNE. Mr. Messemer.

STATEMENT OF GLENN M. MESSEMER, VICE PRESIDENT, SECRETARY, AND GENERAL COUNSEL, KAMAN CORP., BLOOMFIELD, CONN.

Mr. MESSEMER. Thank you, Mr. Chairman, and thank you for the opportunity to appear here today. I understand that my written statement will be made a matter of record, so therefore I will keep my remarks brief. I am Glenn Messemer. I am vice president, secretary, and general counsel of Kaman Corp., a diversified company which is a representative member of the helicopter manufacturing industry, which supports in turn the timber and logging industry.

I am appearing here today in support of a proposal to allow a 3-year recovery period for helicopters used particularly in timber management and harvesting. The purpose of the proposed legislation is to eliminate from the current tax depreciation system what we believe is an unintended bias against helicopters used for this purpose. Recent concern over the damage to the environment, which results from the use of ground-based hauling equipment in timber harvesting operations, has led to the development of helicopters designed and manufactured specifically for use in logging.

Helicopters traditionally used in passenger transportation are designed for passenger capacity, comfort, speed, et cetera, whereas helicopters designed for the logging industry are really what we call aerial trucks, and they favor vertical lift and maneuverability over speed and they are not at all concerned with passenger capacity or comfort. One unfortunate obstacle to the development of this emerging industry is the current unintended tax advantage enjoyed by ground-based hauling equipment over aerial equipment used for the exact same purposes.

As presently in effect, Internal Revenue Code section 168 allows purchasers of ground trucking and transportation equipment to recover the cost of tractor units over a 3-year period under the modified accelerated cost recovery system or over a 4-year period if the alternative depreciation system is applicable.

In contrast, the cost of helicopters used in logging is recoverable over a 5-year period under the modified system or a 6-year period under the alternative depreciation system. This is a 2-year differential in each case to the disadvantage of the aerial truck versus the ground transportation. Given the newness of the use of helicopters designed for the specific purpose, namely timber harvesting, it is understandable why there is no recognition under either the modified accelerated cost recovery system or the alternative depreciation system presently in effect. However, as a result of the similarity of the useful lives between these two different types of aerial versus ground equipment when used in logging, we believe the code should be amended to allow the cost of helicopters used predominantly in timber management harvesting to be recovered over the same period as ground-based hauling equipment, namely a 3-year recovery period under the modified accelerated cost recovery system and a 4-year recovery period under the alternative depreciation system.

Although the principal reason for adopting the proposed legislation is to eliminate an inequity in the cost recovery system, the legislation would also promote two very significant public policies.

First, it would encourage the development of an environmentally sensitive technology. Aerial harvesting with a helicopter avoids the environmentally destructive land clearing required for the ingress and egress of ground-based equipment. Second, the adoption of the proposed legislation would encourage defense conversion. The helicopter manufacturing industry has suffered as a result of the reduction in defense expenditures and the associated downsizing in the industry.

Eliminating artificial barriers to the sale of helicopters to the logging industry would help preserve critical manufacturing capabilities, including the retention of a substantial number of skilled workers needed to produce a highly engineered product such as a helicopter.

Finally, and in conclusion, the adoption of the proposed legislation should prove to be revenue neutral. Cost recovery represents merely a timing difference rather than a permanent difference in taxation, and since the legislation will encourage economic activity that might otherwise be prevented or curtailed because of environmental concerns, the temporary loss of revenue should be offset by additional revenues from incremental economic activity in both the logging industry and in the helicopter manufacturing industry.

Mr. Chairman, thank you once again for permitting me this opportunity to be here today.

[The prepared statement follows:]

GLENN M. MESSEMER
Vice President, Secretary and General Counsel
Kaman Corporation

STATEMENT IN SUPPORT OF A PROPOSAL TO ALLOW A THREE YEAR RECOVERY PERIOD FOR HELICOPTERS USED IN TIMBER MANAGEMENT AND HARVESTING

Mr. Chairman, and Members of the Subcommittee, I want to thank you for this opportunity to appear before you today.

The purpose of the proposed legislation is to eliminate from the current depreciation system an unintended bias against helicopters used in timber management and harvesting.

The use of helicopters in the logging industry arose from the concern over the damage to the environment that results from the use of ground-based hauling equipment in timber harvesting operations. Until recently, these "aerial trucks" were helicopters originally designed for passenger transportation that were acquired in the after-market and converted to use in the logging industry. However, the realization that the long-range effects of existing timber harvesting practices will require logging companies to turn to alternative technologies, has led to the development of helicopters specifically designed for use in logging. While helicopters used in passenger transportation are designed for passenger capacity and comfort as well as speed, helicopters designed for the logging industry favor vertical lift and maneuverability over speed, and are not concerned with passenger capacity or comfort.

One unfortunate obstacle to the development of this emerging industry is the current unintended tax advantage enjoyed by ground-based hauling equipment over aerial equipment used for the same purposes. As presently in effect, IRC §168 allows purchasers of ground trucking and transportation equipment to recover the cost of tractor units over a three-year period under the Modified Accelerated Cost Recovery System ("MACRS") or four-years if the Alternative Depreciation System ("ADS") is applicable. By contrast, the cost of helicopters used in logging is recoverable over a five-year period under MACRS or a six-year period under ADS. This differential arises because the useful life of both trucks and helicopters is determined by reference to the relative useful lives of these two types of assets in all of their commercial applications.

Given the newness of the use of helicopters in timber harvesting it is understandable that there is no recognition under MACRS/ADS as presently in effect. However, inasmuch as it is unlikely that there are any significant differences in the useful lives of trucks and helicopters used in logging, the Code should be amended to allow the cost of helicopters used predominantly in timber management and harvesting to be recovered over the same period as ground-based hauling equipment, namely a three-year recovery period under MACRS and a four-year recovery period under ADS.

Although the principal reason for adopting the proposed legislation is to eliminate an inequity in the cost recovery system, the legislation would also promote two significant public policies.

First, it would encourage the development of an environmentally sensitive technology. Aerial harvesting with a helicopter avoids the environmentally destructive land clearing required for the ingress and egress of ground-base equipment. Fostering the use of helicopters for timber management and harvesting would promote the management and harvesting of timber lands in a more environmentally sensitive manner.

The adoption of the proposed legislation would also encourage defense conversion. The helicopter manufacturing industry has suffered as a result of the reduction in defense expenditures and the associated downsizing in the industry. The industry must be encouraged to adapt to the changing business climate by developing new uses for its product. Eliminating artificial barriers to the sale of helicopters to the logging industry would help preserve critical

manufacturing capabilities including the retention of the substantial number of skilled workers needed to produce a highly-engineered product such as a helicopter.

The adoption of the proposed legislation should prove to be revenue neutral. For one thing, cost-recovery represents a timing difference rather than a permanent difference in taxation. Since the legislation will encourage economic activity that might otherwise be prevented or curtailed because of environmental concerns, the temporary loss of revenue should be offset by additional revenues from incremental economic activity in both the logging industry and the helicopter manufacturing industry.

Mr. Chairman, once again thank you for this opportunity to be here today. I will be more than happy to answer any questions you or the Subcommittee Members may have.

Mr. PAYNE. Thank you very much, Mr. Messemer. We have been called to vote on the floor of the House. I think we have about 4 minutes. I know there are some members who had questions, but I would ask unanimous consent to allow those to be submitted to the record, and you can answer those in writing. Without objection.

[The following was subsequently received:]

QUESTION BY MR. MCCRERY

MR. MOHATAREM, I'VE HEARD CONCERN EXPRESSED THAT PERMITTING SMALL BUSINESSES TO EXPENSE A PORTION OF THE COST OF AN AUTOMOBILE OR LIGHT TRUCK WOULD PROVIDE TAX BENEFITS FOR LUXURY CARS USED IN BUSINESS OR FOR THE PERSONAL USE OF THE VEHICLE. HOW WOULD YOU RESPOND?

RESPONSE OF MUSTAFA MOHATAREM

Existing tax provisions, which would remain in force, preclude tax benefits related to luxury and personal use vehicles. The proposal would not change the so-called "luxury vehicle" depreciation cap of about $13,000. (Since the average selling price of a vehicle today is approximately $17,800, it is a misnomer to call $13,000 a "luxury" cap.) Also, benefits would continue to be specifically prohibited for personal use of vehicles. How these protective measures work to prevent perceived abuse are as follows:

First, with respect to personal use:

- Code Section 179 expensing is not available at all for items used less than 50% for business purposes. If an item is used between 50% and 100% for business purposes, only the business use percentage of the cost of the item is eligible for expensing. Hence, no expensing benefit would be available with respect to the personal use of a vehicle.

- Moreover, to the extent a vehicle is used for personal use, no depreciation deduction is allowed, and a vehicle not used predominantly for business purposes (i.e., more than 50%) cannot be depreciated on an accelerated basis.

Second, with respect to the perception of granting tax benefits for "luxury" vehicles:

- The Code Section 280F "luxury" depreciation limit of approximately $13,000 over a vehicle's five-year recovery period would remain in place. Under the proposal, expensing would be granted only to the extent of this limit. Thus, only the "non-luxury" portion of a vehicle would be eligible for expensing, and then only to the extent it is legitimately used for business. For example, a person using a $90,000 Mercedez Benz for business purposes would receive no greater tax benefit from expensing than someone using a $13,000 Chevrolet delivery van. What would change under the proposal is that a small business that acquires an automobile or light truck for business purposes would be eligible for the same benefits from expensing as a small business that purchases new air conditioners or computers for the office.

REPLY OF CLIFF JERNIGAN,
DIRECTOR, GOVERNMENT AFFAIRS ADVANCED MICRO DEVICES

Response to Questions from Representative Payne at the June 17, 1993 Hearing of Select Revenue Measures Subcommittee

1. The Members of this Committee believe that it is very important to bolster the U.S. economy. Business investment which translates into an increase of U.S.-based jobs is very important. If three-year depreciation for semiconductor manufacturing equipment is enacted, would we see an increase in investment by semiconductor companies over and above planned spending, and if so, how soon could we expect that to occur? Specifically, how would the change effect your company's investment plans?

♦ The National Advisory Committee on Semiconductors (NACS) concluded in their 1990 report on "Capital Investment in Semiconductors" that changing the depreciable life of semiconductor manufacturing equipment from five years to three years would increase capital investment in the U.S. semiconductor industry by 11 percent, over and above planned spending. SIA is unable to conclusively determine how soon investment would increase by individual semiconductor firms; however, we would estimate that investment decisions would be impacted as soon as the change is implemented.

The increased investment by each U.S. semiconductor producer would vary by company size. Given that a piece of semiconductor manufacturing equipment can cost several million dollars, the purchase of even one new piece of equipment a year ahead of today's present buying schedule would have a significant impact on my company's annual capital investment.

2. I am extremely concerned about many U.S. corporations moving their manufacturing facilities offshore. Would the change in depreciable life have a significant impact on a semiconductor company's decision to invest in the United States as opposed to a foreign country?

♦ The change in depreciable life of semiconductor manufacturing equipment would certainly make investment in the United States far more attractive to U.S. producers. The semiconductor industry is very cost competitive and this change would decrease the industry's overall costs and provide needed capital to invest in state of the art technology. Further, the change would bring U.S. depreciation schedules for semiconductor manufacturing equipment closer to the levels our foreign competitors currently enjoy. Compounding the benefit of this change is the increased competitiveness U.S. firms would attain. This increase in competitiveness would then translate into an increase in worldwide market share by U.S. semiconductor companies. It should also be noted that 75 percent of U.S. semiconductor sales made overseas come from wafer fabrication in the United States; U.S. semiconductor companies focus the majority of their R&D efforts in the United States with 95

percent of all R&D expense being in the United States; and, for every three dollars of wages paid in the United States, one dollars of wages is paid abroad.

3. I understand from your testimony that the semiconductor industry is highly competitive. Congress and the Administration want to ensure that U.S. firms are able to compete with foreign firms on a level playing field. How much of an advantage do Japanese semiconductor producers have over U.S. firms?

♦ The U.S. semiconductor industry is very competitive in worldwide semiconductor markets in terms of technology, manufacturing facilities and product designs. In fact, U.S. semiconductor firms outcompete Japan in every market outside Japan. However, in the semiconductor industry, even a small advantage can have a significant impact on a company's ability to compete. Given that the relative competitiveness of individual firms in the semiconductor industry depends upon the company's ability to sustain a high level of capital investment in new plant and equipment, Japanese semiconductor producers enjoy an advantage over U.S. producers due to Japanese depreciation policies. Currently, Japanese semiconductor firms can depreciate up to 88 percent of the cost of their manufacturing equipment in the first year of use while U.S. semiconductor firms are allowed to depreciate only 20 percent of the cost of their manufacturing equipment in the first year. The difference in the depreciable life of semiconductor manufacturing equipment between the Japanese and U.S. governments combined with the many other tax benefits enjoyed by the U.S. industry's chief competitors (i.e., a recent (July 1, 1993) Japanese R&D credit for those firms involved in microprocessor production), gives the Japanese semiconductor industry a significant advantage in the very competitive global semiconductor market.

4. Technology is advancing at a remarkable pace with much of the change directly attributable to advances in semiconductor technology. What is the actual rate of technological obsolescence in the semiconductor industry? How quickly does semiconductor manufacturing equipment depreciate, or actually become obsolete?

♦ As anyone who has witnessed the rapid advances in computer technology over the past decade knows, there is a vast difference between the capabilities of the computers of today compared to the computers of just three years ago. These advances are mainly attributable to advances in semiconductor technology. The semiconductor industry has experienced a change in process technologies or new generations of devices every three to four years. Each change requires the purchase of new equipment to produce the new generation of devices. We expect that this rapid pace of technological obsolescence will continue. A study completed by American Appraisal Associates in 1991 concluded that the actual economic life of semiconductor manufacturing equipment was 3.75 years. This life warrants a three year depreciation rate under the current law depreciation scheduling. Further, our industry's global competitiveness is dependent upon our ability to sustain the required high level of capital investment associated with new, state of the art manufacturing equipment and facilities.

REPLY OF CLIFF JERNIGAN,
DIRECTOR, GOVERNMENT AFFAIRS ADVANCED MICRO DEVICES

Response to Questions from Representative Sundquist at the June 17, 1993 Hearing of Select Revenue Measures Subcommittee

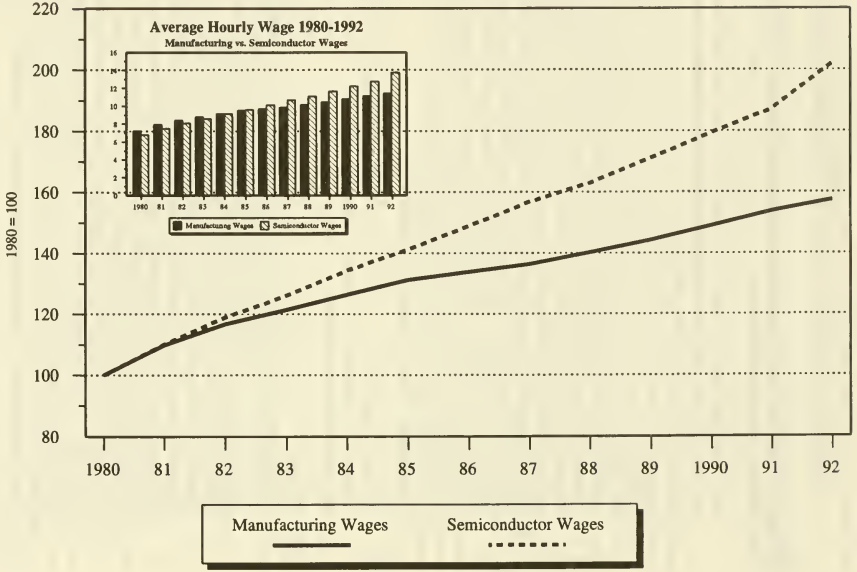
1. Our country is fighting a huge federal deficit which we must make every effort to eliminate. Do you think that this provision would have a positive or negative impact on federal revenues and the economy?

   Response:
   The proposed change to the depreciable life of semiconductor manufacturing equipment from five years to three years will have a positive impact on the U.S. economy which, we believe, will greatly offset any negative impact on federal revenues. A Peat Marwick study completed in 1992 showed a federal revenue cost of approximately $400 million over five years. Although later Joint Tax Committee estimates have varied from this number, the industry firmly believes that the cost of the proposed change will be offset by the impact of the change on the semiconductor and electronics industries. The change will increase sales made by U.S. equipment manufacturers, stimulate employment in the industry and generate greater tax revenue based on a growth in business income -- all necessary elements for stimulating the economy and ultimately reducing the federal deficit. It is clear that the multiplier effects of this bill are substantial.

2. We have heard that it is small business that creates most new jobs and we in Congress are interested in creating high paying jobs in this country. Would three-year depreciation create jobs?

   Response:
   By stimulating investment in the U.S. semiconductor industry Congress would not only increase the number of semiconductor jobs which are, on average, higher paying jobs than those in U.S. manufacturing as a whole (see attached chart which compares semiconductor wages in the United States to manufacturing wages in the United States), but would also stimulate growth in the U.S. semiconductor manufacturing equipment industry which is made up primarily of small U.S. businesses. It has been the stated position of SIA companies to purchase needed equipment and materials from U.S. suppliers. This commitment is clearly evident in the industry's investment in SEMATECH, the government-industry research consortia. Through SEMATECH, semiconductor manufacturers have established closer relationships with their U.S. suppliers. This relationship has led to a turnaround in the decline of U.S. semiconductor equipment sales in the 1980s to a slow and steady increase in market share in the 1990s. The majority of these U.S. equipment makers are small -- less than 100 employees -- companies with yearly sales of less than $25 million.

Semiconductor Wages Have Increased Faster than Manufacturing Wages



CDLA
The Computer Leasing &
Remarketing Association

June 28, 1993

Answers of Kenneth A. Bouldin to Congressman Sundquist's Questions Concerning the Proposal to Depreciate Computers Under the Alternative Minimum Tax at a 200 Percent Declining Balance Rate

1. Q: You said that computers lose their value economically at a very fast rate, in excess of a 200 percent declining balance rate. Why is that?

   A: Computers devalue principally because they very quickly become technologically obsolete. Businesses need to use current technology in order to compete. Because, as everyone knows, the technology has been improving at lightning pace, any particular computer loses its value very fast. We are only asking for a rate that is consistent with economic depreciation. Current regular tax depreciation allowance is not accelerated and therefore the AMT should not use a slower rate.

2. Q: You mentioned that our economic competitors provide substantially more generous tax treatment for computers. How is this likely to affect America's economic position if our tax law isn't changed?

   A: Our inadequate depreciation allowance for computers increases the cost of buying and using computers. Thus, either U.S. taxpayers must pay more for the most recent computer equipment, and operate at a cost disadvantage, or settle for something more outdated, and operate at a technological disadvantage. Either result puts the U.S. at a disadvantage relative to our economic competitors and jeopardizes our ability to succeed in the global market place.

3. Q: If I understand you correctly, the pending Reconciliation bill is a step backward regarding computer depreciation. Why is that?

   A: The AMT provisions in the version of the Reconciliation bill passed by the House would be a step backward. Both of the tax bills which passed Congress last year provided for 150 percent declining balance depreciation

for all assets under the AMT, including computers. The Reconciliation bill which passed the House substantially decreases the rate to 120 percent. Although the bill would also shorten AMT recovery periods where longer than "regular" tax recovery periods, this provides no benefit for computer owners and users. Thus, the pending proposal is substantially less helpful than what Congress passed twice last year.

The AMT provisions in the Senate's version of the Reconciliation bill, in contrast, would provide significant relief for computer owners and users by increasing the AMT depreciation rate to the 150 percent declining balance rate for all assets, as in last year's bills. Even more appropriate relief would be provided by the Andrews bill (H.R. 1956), which would provide 200 percent declining balance depreciation for computers.

Mr. PAYNE. Mr. McCrery.

Mr. MCCRERY. Thank you, Mr. Chairman. I just want to thank General Motors and Mr. Mohatarem for testifying on behalf of my suggestion that we change the Tax Code to allow small business folks to utilize the expensing item in the Tax Code for the purchase of automobiles as well as other capital expenditures. I am hopeful that the members of the committee will give due consideration to what you have had to say today. Thank you.

Mr. MOHATAREM. Thank you.

Mr. PAYNE. Did you have anything, Peter?

Mr. HOAGLAND. No.

Mr. PAYNE. Let me thank this panel very much for your testimony for the information that you provided. It certainly will be very, very helpful to us as we continue in the legislative process, and we appreciate your time and the time that you took to prepare this testimony.

Thank you very much, and the committee is adjourned until June 22 at 10 a.m.

[Whereupon, at 3:30 p.m., the subcommittee was adjourned, to reconvene at 10 a.m., Tuesday, June 22, 1993.]

MISCELLANEOUS REVENUE ISSUES

TUESDAY, JUNE 22, 1993

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
SUBCOMMITTEE ON SELECT REVENUE MEASURES,
Washington, D.C.

The subcommittee met, pursuant to call, at 10:15 a.m., in room 1100, Longworth House Office Building, Hon. Charles B. Rangel (chairman of the subcommittee) presiding.

Chairman RANGEL. The Subcommittee on Select Revenue Measures will come to order this morning, and we will begin the second of several days of hearings on the miscellaneous revenue issues. The subcommittee today will receive testimony from the Treasury Department on the revenue issues that were described in the press releases of June 2 and 11. In addition the subcommittee will receive testimony from other witnesses on issues previously announced before for today's hearing.

Because of the large number of witnesses and the desire of the committee to question, we ask those who are scheduled to testify to limit their oral testimony to 5 minutes. I realize that you cannot make all of the points that you would like to make in that short period of time, but be assured that your entire written testimony will be made available to the subcommittee members for review, and without objection of the subcommittee will be entered into the record.

At this time, the Chair has been informed that the chairman of the banking committee of New York State, Denny Farrell is with us. On behalf of the committee I would like to welcome him. Is he somewhere? Chairman Farrell. The Chair now yields to Mr. Hancock.

Mr. HANCOCK. Thank you, Mr. Chairman. In the interest of time and with a lot of work to do, let's get on with it.

Chairman RANGEL. Are there any members seeking recognition? Mrs. Johnson.

Mrs. JOHNSON. Thank you, Mr. Chairman. Just very briefly, I appreciate the subcommittee's indulgence and your hard work on all of these provisions. I would just like to call your attention to my provision to allow people on unemployment compensation to request the right to have taxes withheld from their unemployment compensation benefits since those benefits are taxable. I appreciate the committee's attention to these things, and I am pleased that one of my local community bankers will be testifying on your last panel. Ed Lorenson is a man of tremendous experience, and I am

pleased that grassroots people will be here before you to give you their insights. Thank you, Mr. Chairman.

Chairman RANGEL. Well, we thank him for taking the time to share his views with the committee. Of course, it is with great honor that I present to the committee our distinguished colleague from New Mexico, one who is so active in trade and foreign affairs, and we indeed are fortunate for you to share your views on these revenue matters today. The Honorable Bill Richardson of New Mexico.

STATEMENT OF HON. BILL RICHARDSON, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NEW MEXICO, AND CHAIRMAN, SUBCOMMITTEE ON NATIVE AMERICAN AFFAIRS, COMMITTEE ON NATIONAL RESOURCES

Mr. RICHARDSON. Mr. Chairman, members of the subcommittee, thank you for the opportunity to testify at your series of hearings. Mr. Chairman, first let me commend you and your subcommittee for the work you have done on the empowerment zones. I will be testifying today on tax credits for the Indian nations in this country, and I first want to commend you for the work that you and the subcommittee have done in the enterprise zones which will benefit five Native American reservations.

My focus today, Mr. Chairman, is on a single issue that is of urgent importance and falls squarely within Ways and Means jurisdiction, and that is the Indian employment and investment tax credits which the Congress passed last October as sections 1131 and 1132 of the vetoed Revenue Act of 1992, H.R. 11. I have reintroduced those identical provisions in H.R. 1325, the Indian Employment and Investment Act of 1993. A companion bill has been reintroduced in the Senate. I would urge this subcommittee to show the leadership that will put the House in the forefront on this issue and that will lead to readoption in 1993 of the very provisions that we passed last October.

This measure will stimulate the economy in Indian country by providing new businesses Federal tax incentives to locate on reservations. First, an employment credit provides for a credit to the employer based on the qualified wages and qualified health insurance costs paid to Indian employees. Second, the bill provides for a credit for personal property for new construction property and for infrastructure investment on or near reservations. This investment tax credit is limited to reservations where the unemployment levels exceed the national average by at least 300 percent. Restrictions in the measure preclude both credits from being used for the development or operation of gaming establishments on reservations. These investment credits will serve to attract new businesses to Indian reservations by reducing costs associated with locating businesses on reservations. It will offset additional costs of doing business on Indian reservations due to a lack of adequate infrastructure and significantly increase employment opportunities on Indian reservations.

Mr. Chairman, reservations are among the most severe examples of poverty in America. 93,000 Indian people are homeless or underhoused, according to the Bureau of Indian Affairs. Twenty percent of Indian homes lack toilets and half don't have telephones.

Unemployment on reservations has always exceeded 50 percent nationally and is over 80 percent on some reservations. Nowhere, and I repeat nowhere in the United States can you find adverse economic conditions that rival those found consistently throughout Indian country. Poverty rates are alarming and debilitating to Indian children and Indian families. Infrastructure that most Americans take for granted is often nonexistent.

In the Navajo Nation, for example, there are 2,000 miles of paved roads. West Virginia, which is the same size, has over 18,500 miles. Running water, electricity, and other so-called necessities of life are often unavailable. This lack of infrastructure invariably results in substantially higher nonwage costs for private sector investors and employers and constitutes the principal deterrent to locating new, job-producing businesses on the reservations. Another deterrent is double taxation by the States on non-Indian business conducted entirely within reservations. I have reintroduced legislation to address this problem, H.R. 478, and hope the committee will look carefully at this issue in the future.

In H.R. 11, Congress recognized that the unique circumstances of Indian country require unique treatment. The House conferees accepted those Senate-passed provisions and the Congress subsequently adopted them. Having sought tax incentives of this type for some 10 years, Indian country rejoiced, but the celebration was short-lived when the legislation was vetoed on the day following the election. The 103d Congress should finish the job, and we should do it this year.

Now, some may question the advisability for establishing a separate tax incentives program for Indian country, but they would be wrong. Our laws allow for it. Recent legislation requires it and sound public policy and our moral responsibilities demand it. First, Native American tribes have a unique legal and political status in our country, and their relationship with the Federal Government is on a government-to-government basis. This status is well-recognized in treaties, trust obligations, statutes, and case law. Adopting a separate reservation-based program is consistent with this unique status and has been upheld by the Supreme Court.

Second, as previously noted, reasoned legislation and common sense requires that we legislate a response that fits the problem. A limited Indian country empowerment-enterprise zone proposal does not go far enough. Participation in a nationwide incentive offering the same level of benefits within Indian country as in non-Indian areas does not offer the needed Indian differential to help overcome infrastructure deficiencies and related Indian country development barriers not shared by other areas.

Third, the staggering unemployment and poverty rates on reservations demand that we take innovative new approaches to address it. Frankly, adoption of the Indian employment and investment tax credits should be among the easier decisions to be made in the 1993 tax legislation. The needs are demonstrated without question. The tax credits are relatively modest in cost, with the Joint Committee on Taxation providing a revenue estimate of $209 million over a 5-year period. The credits do not funnel funds into creating and perpetuating a new governmental bureaucracy, but

instead are available directly to the private sector. They focus on creating new jobs where they are most needed.

For example, the full reservation investment tax credit is available only at reservations exceeding the national average unemployment rate by at least 300 percent. They promote infrastructure investment where it is sorely needed. The tax credits are understandable to investors and employers, and easy to administer. They offer potential benefit for all of Indian country, rather than to a very few reservations. They were initiated by the country's largest Indian tribe, the Navajo Nation, and are backed strongly by the National Congress of American Indians and its members throughout the United States, and many other tribes.

My understanding, Mr. Chairman, is that later in the fifth panel some of these tribes will be testifying. We have already passed these provisions which have continuing bipartisan support. The lead sponsor in the Senate is Senator John McCain of Arizona. Let us pick up where we left off last fall.

I ask the subcommittee and the House to take the lead on this important issue, one that then candidate Clinton endorsed in his campaign for President and hopefully we will make sure, Mr. Chairman, that this legislation complements the excellent work that you and this committee have started in the empowerment zones, both necessities in ensuring that we have some jobs on the reservation. As chairman of the Indian Subcommittee in the House Natural Resources, Mr. Chairman, there is no larger and more important priority for Indian country than this one, and I thank the gentleman.

[The prepared statement follows:]

STATEMENT OF CHAIRMAN BILL RICHARDSON
SUBCOMMITTEE ON NATIVE AMERICAN AFFAIRS
BEFORE THE SUBCOMMITTEE ON SELECT REVENUE MEASURES
COMMITTEE ON WAYS AND MEANS
June 22, 1993

On Indian Employment and Investment Tax Credits

Mr. Chairman, Members of the Subcommittee, I appreciate this opportunity to testify at your series of hearings on various miscellaneous revenue issues.

My focus today is on a single issue that is of urgent importance and that falls squarely within Ways and Means jurisdiction -- the Indian Employment and Investment Tax Credits which Congress passed last October as Sections 1131 and 1132 of the vetoed "Revenue Act of 1992" (H.R. 11). I have re-introduced those identical provisions in H.R. 1325, the "Indian Employment and Investment Act of 1993"; a companion bill, S. 211, has been re-introduced in the Senate by Chairman Daniel Inouye and Co-Chairman John McCain of the Committee on Indian Affairs. I urge the Subcommittee to exercise the leadership that will put the House in the forefront on this issue, and that will lead to re-adoption in 1993 of the very provisions that we passed last October.

This measure will stimulate the economy in Indian country by providing new businesses federal tax incentives to locate on reservations. First, an employment credit provides for a 10% credit to the employer based on the qualified wages and qualified health insurance costs paid to Indian employees. A credit of 30% is offered to employers having an Indian work force of at least 85%. This credit is limited to "new hires" and to those employees who do not receive wages in excess of $30,000. The credit would only be allowed on the first seven years of employment. This tax credit will begin to address the severe unemployment problems in Indian country. It will stimulate job creation on Indian reservations and significantly reduce Indian unemployment on reservations.

Second, the bill provides for a 10% credit for personal property, 15% for new construction property and 15% for infrastructure investment on or near reservations. This investment tax credit is limited to reservations where the unemployment levels exceed the national average by at least 300%. On reservations where unemployment exceeds 150% of the national average, half of the credit would be available for qualifying investments . Restrictions in the measure preclude both credits from being used for the development of operation of gaming establishments on reservations. These investment credits will serve to attract new businesses to Indian reservations by reducing costs associated with locating businesses on reservations. It will offset additional costs of doing business on Indian reservations due to a lack of adequate infrastructure and significantly increase employment opportunities on Indian reservations.

There can be little doubt about the urgency of enacting these complementary employment and investment tax incentives to help tribal leaders -- at reservations in 32 states across the country -- in their efforts to build infrastructure, provide jobs, and offer hope to their people. Mr. Chairman, the entire country has been suffering during these hard economic times, and the new Congress and the new Administration are working together in a new spirit of cooperation to pull this country back to the prosperity that all Americans deserve. However, unspeakable living conditions in Indian country set Indian reservations apart from the hardest-hit inner cities and rural areas - and demand special attention and the meaningful, new private sector-oriented incentives that the Indian country tax credits will provide.

Mr. Chairman, Indian reservations are among the most several examples of poverty in America. 93,000 Indian people are homeless or underhoused, according to the Bureau of Indian Affairs. 20% of Indian homes lack toilets and half don't have telephones. Of the 1.8 million Native Americans in the United States, 603,000 live below the poverty line. Of those, 85,000 are under the age of five. Indian youth have the highest dropout rate of any

minority group at 35.5%. Unemployment on reservations has always exceeded 50% nationally and is over 80% on some reservations.

As the Nation reviews its health needs, it can look to American Indians as the ethnic group in the poorest health, with the highest rates of diabetes and tuberculosis of any minority group. Recently, Indian Health Service reported that tuberculosis rates among Native Americans exceeded all other minorities by 400%. Indians die younger than other groups, from a variety of illnesses. A report last year from the University of Minnesota showed that the suicide rate of Indian teens is four times greater than any other ethnic minority. Even the accidental death rate of American Indians is 295% greater than the rate for the U.S. population. Given the lack of primary health care provided to Indian people, it is surprising that the epidemic that occurred in New Mexico on the Navajo reservation doesn't happen on more reservations nationwide.

Nowhere -- I repeat nowhere -- in the United States can you find adverse economic conditions that rival those found consistently throughout Indian country. Poverty rates are alarming, and debilitating to Indian children and Indian families. Infrastructure that most Americans take for granted is often non-existent. In the Navajo Nation, for example, there are 2,000 miles of paved roads; West Virginia, which is the same size, has over 18,500 miles. Running water, electricity and other so-called necessities of life are often unavailable.

This lack of infrastructure invariably results in substantially higher non-wage cost for private sector investors and employers, and constitutes the principal deterrent to locating new, job-producing businesses on Indian reservations. Another deterrent is "double taxation" by the states on non-Indian business conducted entirely within reservations; I have re-introduced legislation to address this problem (H.R. 478), and hope that the Committee will look carefully at this issue in the future.

Unless we legislate to provide tribal leaders with the type of powerful new incentives that these Indian country tax credits represent, the existing unconscionable conditions promise only to worse. And make no mistake about it: while American's foreign aid programs have rightfully helped improve the standard of living in many needy countries abroad, we have here within our borders -- on Indian reservations in 32 states -- American citizens who have perpetually lived in conditions far worse than exist in many of the countries to whom we provide that foreign aid. In "putting people first," the first place we should look is at Indian country.

Now Mr. Chairman, it would be easy simply to assume that Indian country might benefit from the nationwide tax incentives such as an extended/expanded targeted jobs tax credit, and to leave it at that -- but we would be wrong. Such measures do not provide sufficient added incentives to overcome the infrastructure deficiencies that pose a substantial barrier to investment in Indian country. Moreover, nationwide incentives like a targeted jobs tax credit will not help to attract -- as would the Indian country tax incentives -- larger, labor-intensive industrial investment that is most likely to entail new facilities of existing large business enterprises. Finally, of those incentives, if available elsewhere in the United States, will not provide the added inducement necessary to help level the playing field so that Indian country can begin to compete against other areas.

Similarly, Mr. Chairman, it would be easy simply to assume that Indian country might benefit from the one Indian empowerment zone and five enterprise communities that the House has passed, and to leave it at that -- but we would be wrong. Regrettably, this is a "solution" to Indian country unemployment that bears no reasonable relationship to the problem. Unemployment on Indian reservations is a nationwide problem as identifiable locations across the country, and it demands a nationwide response such as that offered by the Indian Employment and Investment Tax Credits. Helping a very few reservations with zones will only destroy hope at those other locations not selected.

Moreover, it is unrealistic to believe that empowerment/ enterprise zones at Indian reservations will be able to compete against non-Indian zones offering the same tax

incentives and benefits. Again, the higher infrastructure cost would in virtually all instances cause potential investors and employers to choose the zones at non-Indian area which already have the roads, telephones, etc. that are lacking in Indian country. Thus, empowerment/ enterprise zones -- even for the 6 reservations that are selected -- will do nothing to level the playing field that currently prevents Indian country from competing effectively against even the most distressed non-Indian areas.

In H.R. 11, Congress recognized that the unique circumstances of Indian country required unique treatment. The House Conferees accepted those Senate-passed provisions and the Congress subsequently adopted them. Having sought tax incentives of this type for some ten years, Indian country rejoiced; but the celebration was short-lived, as President Bush vetoed the legislation on the day following the election.

The 103d Congress should finish the job, and we should do this year. Now, some may question the advisability of establishing a separate tax incentives program for Indian country, but they would be wrong. Our laws allow for it; reasoned legislating requires it; and sound public policy and our moral responsibilities demand it.

First, Indian tribes have a unique legal and political status in our country, and their relationship with the Federal government is on a government-to-government basis. This status is well-recognized in treaties, trust obligations, statutes and case law. Adopting a separate, reservation-based program is consistent with this unique status, and has been upheld by the Supreme Court.

Second, as previously noted, reasoned legislation -- and common sense -- requires that we legislate a response that fits the problem. A limited Indian country empowerment/enterprise zone proposal does not go far enough. Participation in a nationwide incentive offering the same level of benefits within Indian country as in non-Indian areas does not offer the needed "Indian differential" to help overcome infrastructure deficiencies and related Indian country economic development barriers not shared by other areas.

Third, the staggering unemployment and poverty rates on Indian reservations demand that we take innovative new approaches to address them. As President Zah testified:

> Stated simply, there is no single group of U.S. citizens that -- uniformly -- is more economically-deprived than American Indians living on reservations; there is no classifiable set of locations that -- uniformly -- is more deficient in job opportunities than Indian reservations.

Frankly, adoption of the Indian Employment and Investment Tax Credits should be among the "easier" decisions to be made in the 1993 tax legislation. The needs is demonstrated, and unquestioned. The tax credits are relatively modest in cost, with the Joint Committee on Taxation providing a revenue estimate of $209 million over a five-year period. The credits do not funnel funds into creating -- and perpetuating -- a new governmental bureaucracy, but instead are available directly to the private sector. They focus on creating new jobs where they are most needed. (For example, the full reservation investment tax credit is available only at reservations exceeding the national average unemployment rate by at least 300%.) They promote infrastructure investment where it is sorely needed. The tax credits are understandable to investors and employers, and easy to administer. They offer potential benefits for all of Indian country, rather than to a very few reservations. They were initiated by the country's largest Indian tribe, the Navajo Nation, and are backed strongly by the National Congress of American Indians and its members throughout the United States, and many other tribes.

And, we have already passed these provisions, which have continuing bipartisan support. Let us pick up where we left off last fall. I ask the Subcommittee -- and the House -- to provide the leadership that will at last incorporate these urgently-needed tax incentives into our nation's tax code and tax policies.

Chairman RANGEL. Well, I thank you, Congressman Richardson, for your enlightened testimony, and I am really grateful that you brought this issue to the attention of the subcommittee, because certainly no inner city or even rural pockets of poverty actually reach the extent of pain and misery that we have on our Indian reservations.

I should know this, but assuming that we pass the bill out in the manner in which the House did, how does the bill interact with a nation as opposed to local and State governments?

Mr. RICHARDSON. Mr. Chairman——

Chairman RANGEL. The reason for my question is that with the independence of the Indian nation, would we have any ability for oversight to make certain, as we do in the inner cities, that the benefits of the legislation remained within that subdivision as opposed to going to outside investors and outside developers?

Mr. RICHARDSON. Mr. Chairman, under our statutes the Federal Government does have oversight over all Native American activities, including this one. Both the Bureau of Indian Affairs and the IRS would have oversight over these matters.

Chairman RANGEL. And we could rely on you to draft the report language to make certain that we can minimize the possibilities of exploitation which we have had to do with our bill as relates to the problems we face in the inner cities?

Mr. RICHARDSON. We would make sure, Mr. Chairman, that proper report language is drafted to ensure that.

Chairman RANGEL. Well, I am proud to work with you on this. As you and I know, this is merely a pilot demonstration project and falls far short of what we should be doing, but as you testified, this is a beginning and perhaps a model for the country and Congress to follow, so thank you for your testimony.

Mr. Hoagland.

Mr. HOAGLAND. Mr. Richardson, as you know, many of us in the Midwest are concerned about the spread of Indian casino gaming. In Minnesota and South Dakota, in Wisconsin we are seeing full-fledged Nevada-Atlantic City type gaming casinos being established on Indian reservations. It seems to me that your proposal here is a much better long-term way of assuring economic growth and stability on Native American lands as opposed to casino gambling, and I wonder if you have any reflections on the comparative value of the two.

Mr. RICHARDSON. Well, I agree with you, Mr. Hoagland, and I have noticed that the bill that you have introduced that deals with Indian gaming also contains a provision for tax credits and for job creation on the reservation the way this legislation is drafted. I think this is far better. I would like to see our Native American tribes not be exclusively reliant on gaming, as receptacles of nuclear waste, that is another disturbing trend that we see, and that they get into the private sector. And one of the problems has been a lot of red tape and bureaucracy within the Indian nation, and within the Bureau of Indian Affairs that prevents the private sector from coming in and getting jobs created and setting up plants and training people, and I would much prefer this type of legislation than gaming, but gaming has become an option.

My subcommittee is holding hearings, as you know, on the issue to see if we need clarifications on that matter, but I think this legislation is the single most important initiative we could take with Indian country. We don't have the budget and the money to just pump money into the reservation. That is no longer possible, and I think through this effort we can get the public and private sector working together to bring jobs into parts of this country that are the most in need by far, and that includes, with all due respect, some of the areas in some of our urban ghettos.

Mr. HOAGLAND. Well, let me say that I think your efforts in bringing in this legislation are to be praised because of the fact that it puts the spotlight on problems of Indian poverty and slow economic development on reservations, and all of us who are concerned about Indian gaming, I think, are very much concerned about the poverty problems, and are looking for vehicles to return that to the top of the priority list, and sincerely believe that we need to deal with those issues, but that we also should return control of all casino gambling to the State legislatures and the Governors so they can be regulated informally throughout a State. But clearly your bill addresses a major need, and I am delighted that you are presenting it and I hope we can act on it. Thank you, Mr. Chairman.

Chairman RANGEL. Mr. Payne.

Mr. PAYNE. Thank you very much, Mr. Chairman. I didn't have a question, but wanted to thank Bill Richardson for his testimony and to thank him for the leadership that he provides in all matters having to do with Native Americans. I think this is well-reasoned, well-thought-out legislation, and look forward to working with you on this. Thank you.

Mr. RICHARDSON. Thank you.

Chairman RANGEL. Are there any other members seeking recognition? Let me thank you again for the contribution you made to the committee and to our Congress.

Mr. RICHARDSON. Thank you, Mr. Chairman.

Chairman RANGEL. Now we have Hon. Leslie B. Samuels from the Treasury Department, Assistant Secretary for Tax Policy. I think this is the first time that we have had the honor of having you testify in front of this committee. Your full statement, as with other witnesses, will be entered into the record without objection, and you can highlight your views on the legislation before us in the manner that you feel comfortable. Of course, the Chair always welcomes our old friend, Mr. Sessions. We look forward to working with him in the immediate future. Secretary Samuels.

STATEMENT OF HON. LESLIE B. SAMUELS, ASSISTANT SECRETARY FOR TAX POLICY, U.S. DEPARTMENT OF THE TREASURY

Mr. SAMUELS. Mr. Chairman and members of the subcommittee, I am pleased to present the views of the administration on the miscellaneous tax proposals that are the subject of these hearings. These proposals are described in the June 16, 1993 pamphlet prepared by the Joint Committee on Taxation, JCS–8–93, and a June 1, 1993 subcommittee announcement on "Tax Issues Affecting

the Health and Safety of Inner-city Residents and Other Miscellaneous Health-related Tax Issues."

Congress and the administration are currently in the process of considering the budget reconciliation legislation. This legislation represents the largest deficit reduction package in the history of the Nation. The goals which have guided the administration in the budget reconciliation process should be used as a guide as we consider the measures which are before the subcommittee today.

Chairman RANGEL. Mr. Samuels, this is the first time you have ever been before our committee, I just wanted to inform you, you are not compelled, of course, to read the entire statement, but, of course——

Mr. SAMUELS. Mr. Chairman, I propose to read the introduction and take some questions.

Chairman RANGEL. Whatever makes you feel comfortable. I just wanted to point that out.

Mr. SAMUELS. OK. These goals include retaining progressivity and fairness in the tax system, minimizing revenue increases and maximizing spending cuts without placing an excessive burden on those least able to afford it, encouraging economic growth and ensuring that the deficit is reduced over time. The administration is unable to support proposals that are incompatible with these goals.

The House and Senate Finance Committee have passed a revenue bill, H.R. 2264. The administration supports the position of the House and Senate Finance Committee that H.R. 2264 should not contain miscellaneous revenue-losing provisions. Consequently, the administration is opposed to expanding the scope of that bill to include such proposals. Moreover, we believe that with respect to proposals that directly relate to the revenue reconciliation bill, it would be more appropriate to state the administration's position as part of the consideration of that legislation.

The subcommittee has before it over 170 proposals. These proposals are generally not presented as technical corrections but represent substantive changes to a wide range of tax provisions. Many of these proposals deal with complex provisions of the law. In many cases the proposals raise questions of whether existing law should be thoroughly reviewed and subject to hearings. For example, proposed amendments to the rules applicable to S corporations suggest that it may be time to review the treatment of S corporations. We note that H.R. 13 and H.R. 17 contain certain simplification provisions. Complexity in the tax law raises serious compliance and administrative problems. These problems have grown over time and now deserve serious attention. Accordingly, we look forward to working with interested parties and Congress in developing simplification proposals, including a review of the simplification provisions of H.R. 13 and H.R. 17.

The administration is also aware that many subcommittee members are interested in the miscellaneous tax proposals contained in H.R. 13 and H.R. 17. While the administration has not been asked to testify on these bills, we note for the subcommittee that a number of the items in those bills raise significant tax policy concerns which we would be pleased to discuss at a later time.

In developing our positions on the proposals before the subcommittee today, we have relied on a number of tax policy prin-

ciples. These principles include supporting tax simplification efforts within the constraints of deficit reduction, opposing rifle shot measures that provide special benefits to a targeted group of taxpayers, opposing purely retroactive provisions that seek to supplant the judicial process, and considering the administerability of each measure.

Finally, to the extent that miscellaneous tax proposals represent tax expenditures, the relevant cost to taxpayers and the proposed revenue-raising offsets are important factors to be considered.

The subcommittee has announced that revenue-raising measures and other additional miscellaneous issues will be the subject of future hearings. The administration's views with respect to many of the proposals under consideration today assume that appropriate offsetting revenue measures will be proposed. Consequently, even for tax proposals that are meritorious, they must be offset by revenue-raising provisions that are compatible with the principles of deficit reduction. Moreover, even if revenue-raising offsets can be identified, the administration will wish to work with the subcommittee and the Congress as a whole to set priorities for the use of those revenues.

The remainder of the written statement is a detailed discussion of the administration's provisions and the order of presentation follows the proposals described in the Joint Committee pamphlet.

Mr. Chairman, that concludes my remarks and I will be happy to answer any questions that you or other members of the committee may wish to ask.

[The prepared statement follows:]

STATEMENT OF
LESLIE B. SAMUELS
ASSISTANT SECRETARY (TAX POLICY)
DEPARTMENT OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON SELECT REVENUE MEASURES
OF THE
HOUSE COMMITTEE ON WAYS AND MEANS

Mr. Chairman and Members of the Subcommittee:

I am pleased to present the views of the Administration on the miscellaneous tax proposals that are the subject of these hearings. These proposals are described in the June 16, 1993 pamphlet prepared by the Joint Committee on Taxation[1] ("JCT Pamphlet"), and a June 1, 1993 Subcommittee announcement on "Tax Issues Affecting The Health And Safety Of Inner-city Residents And Other Miscellaneous Health-related Tax Issues."[2]

Congress and the Administration are currently in the process of considering the budget reconciliation legislation. This legislation represents the largest deficit reduction package in the history of the Nation. The goals which have guided the Administration in the budget reconciliation process should be used as a guide as we consider the measures which are before the Subcommittee today.

These goals include retaining progressivity and fairness in the tax system; minimizing revenue increases and maximizing spending cuts without placing an excessive burden on those least able to afford it; encouraging economic growth; and ensuring that the deficit does not increase. The Administration is unable to support proposals that are incompatible with these goals.

The House and the Senate Finance Committee have passed a revenue bill, H.R. 2264. The Administration supports the position of the House and Senate Finance Committee that H.R. 2264 should not contain miscellaneous revenue losing provisions.

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[1] Joint Committee on Taxation, Description of Miscellaneous Tax Proposals (JCS-8-93), June 16, 1993.

[2] See, Press Release #3, Subcommittee on Select Revenue Measures, Committee on Ways and Means (June 1, 1993).

Consequently, the Administration is opposed to expanding the scope of that bill to include such proposals. Moreover, we believe that with respect to proposals that directly relate to the revenue reconciliation bill, it would be more appropriate to state the Administration's position as part of the consideration of that legislation.

The Subcommittee has before it over 170 proposals. These proposals are generally not presented as technical corrections, but represent substantive changes to a wide range of tax provisions. Many of these proposals deal with complex provisions of the law. In many cases, the proposals raise questions of whether existing law should be thoroughly reviewed and subject to hearings. For example, proposed amendments to the rules applicable to S corporations suggest that it may be time to review the treatment of S corporations. The last review of S corporations took place in 1982. Since then, the number of S corporations has nearly tripled. Moreover, changes in the tax law, including the repeal of the General Utilities doctrine, suggest that S corporations may be even more important today. The Administration believes that all of the S corporation tax proposals should be carefully considered in the context of a comprehensive review of the S corporation rules. This review should consider among other things simplification and rationalization of those rules.

We note that H.R. 13 and H.R. 17 contain certain simplification provisions. Complexity in the tax law raises serious compliance and administrative problems. These problems have grown over time and now deserve serious attention. Accordingly, we look forward to working with interested parties and Congress in developing simplification proposals, including a review of the simplification provisions of H.R. 13 and H.R. 17.

The Administration is also aware that many Subcommittee members are interested in the miscellaneous tax proposals contained in H.R. 13 and H.R. 17. While the Administration has not been asked to testify on H.R. 13 and H.R. 17, we note for the Subcommittee that a number of the items in those bills raise significant tax policy concerns, which we would be pleased to discuss at a later time.

In developing our positions on the proposals before the Subcommittee today we have relied on a number of tax policy principles. These principles include supporting tax simplification efforts within the constraints of deficit reduction; opposing "rifleshot" measures that provide special tax benefits to a targeted group of taxpayers; opposing purely retroactive provisions that seek to supplant the judicial process; and considering the administrability of each measure. Finally, to the extent that miscellaneous tax proposals represent tax expenditures, the relevant cost to taxpayers, and the

proposed revenue raising offsets, are important factors to be considered.

The Subcommittee has announced that revenue raising measures and other additional miscellaneous issues will be the subject of future hearings.[3] The Administration's view with respect to many of the proposals under consideration today assumes that appropriate offsetting revenue measures will be proposed. Consequently, even for tax proposals that are meritorious, they must be offset by revenue raising provisions that are compatible with the principles of deficit reduction. Moreover, even if revenue-raising offsets can be identified, the Administration will want to work with the Subcommittee and the Congress as a whole to set priorities for the use of those revenues.

The remainder of my written statement is a detailed discussion of the Administration's positions on the miscellaneous tax proposals which are the subject of this hearing. The discussion follows the order of the proposals described in the JCT Pamphlet and the June 1, 1993 Subcommittee announcement.

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[3] See, Press Release #4, Subcommittee on Select Revenue Measures, Committee on Ways and Means (June 2, 1993).

ADMINISTRATION POSITION ON MISCELLANEOUS TAX PROPOSALS

A. TAX ACCOUNTING PROVISIONS

1. Treatment of Contributions in Aid of Construction (H.R. 846)

Administration Position. **Do not oppose.** The current treatment of contributions in aid of construction ("CIACs") was added to the Internal Revenue Code (the "Code") in 1986. It could be a argued that a CIAC represents prepaid income because it replaces the income flow that the utility would have charged had it been required to provide the contributed property with its own funds. However, if the utility is generally restricted to a fixed rate structure so that it cannot earn a return on the contributed property, this prepaid income analysis does not appear appropriate.

As a matter of tax policy, it is difficult to justify excluding CIACs received by water or sewer companies but not other utilities. Moreover, there are certain technical issues raised by H.R. 846, such as whether the proposal should be effective for binding contracts in effect on the date this committee acts, instead of the date of enactment.

2. Capitalization of Certain Costs Associated with Natural Disasters

Administration Position. **Do not support.** The Administration is aware of concerns regarding lost or damaged crops, such as the problems of the wine industry caused by phylloxera B. The proposal, however, allows current tax deductions for the cost of assets that provide increased value to the industry beyond restoring crops to their condition before the damage occurs. For example, the value of a vineyard could be substantially increased from the use of new technologies related to irrigation systems, drainage tiles and trellis systems. From a tax policy perspective, it appears appropriate to permit current tax deductions for costs incurred to place a grove, orchard or vineyard back into the state it was prior to destruction. In the case of a vineyard, for example, these deductions include the costs of removal of infested plants, removal and disposal of old assets, land preparation and the planting of new plants.

3. Treatment of Platinum Fabricated into Items Used in a Trade or Business

Administration Position. **Oppose.** Revenue Ruling 90-65 is the

correct interpretation of the tax law. The ruling held that if economically recoverable precious metals are physically or chemically fabricated into property used in a taxpayer's trade or business, and the cost of those precious metals represents more than half the cost of the new property, the cost of the precious metals is nondepreciable and is accounted for separately from the item into which the metals are fabricated. The ruling also states that any change in method of accounting to conform with the holding in the ruling must be made with the consent of the Commissioner and a section 481(a) adjustment would be provided.

The proposal allows the change in method of accounting to comply with Revenue Ruling 90-65 to be made on a cut-off basis for parts placed in service in taxable years beginning after August 13, 1990. Allowing the change in accounting method to be made on a cut-off basis inappropriately permits a deduction for platinum fabricated into property in prior years, when capitalization was the proper tax treatment.

B. FINANCIAL INSTITUTIONS PROVISIONS

1. Tax Incentives for Minority-owned Financial Institutions

Administration Position. **Oppose.** Incentives to assist minority-owned financial institutions should not be provided through the tax system, particularly when the incentives are not based upon economic circumstances. The failure to target the proposal to disadvantaged persons results in a substantial potential revenue loss, which we estimate to be approximately $850 million over the FY 1994-98 budget period.

In addition, the proposed change to the loss carryforward rules would undermine policies of FIRREA directed at preventing trafficking in loss carryforwards.

2. Permit Common Trust Funds to Transfer Assets to Regulated Investment Companies Without Taxation

Administration Position. **Do not oppose.** This proposal is an expansion of a related proposal from H.R. 13. This proposal, in combination with the proposal from H.R. 13, provides that smaller banks, without sufficient funds to create proprietary mutual funds, may transfer their common trust funds to one or more larger mutual funds. A similar result could be achieved without this amendment by dividing the trust fund and subsequently converting the divided funds into RICs. The amendment allows taxpayers to achieve this result in one step, although there are some concerns about basis allocation rules.

3. Treat Small Finance Companies as Small Banks for Bad Debt Deduction Purposes.

Administration Position. **Oppose.** The reserve method may distort both the timing and amount of deductions because it permits deductions to be claimed before the associated losses occur. The method may overstate the amount of deductions because the anticipated losses are not discounted to present value.

If finance companies with assets under $500 million are given the option of using the reserve method, it will be difficult to distinguish other similar businesses with receivables on tax policy grounds. As a result it would be difficult to prevent further extension of this tax benefit to other similar businesses. In addition, the need for a tax subsidy to promote finance company growth is not apparent. Finance companies doubled their market share relative to financial institutions over the last two decades.

4. Treatment of Consolidation of Certain Mutual Savings Bank Life Insurance Departments

Administration Position. **Do not oppose.** The Administration does not oppose this proposal as long as it is limited to consolidation of life insurance departments of mutual savings banks under section 594 under requirement of state law, the provision applies only when the policyholders had no rights to surplus and no voting rights prior to the consolidation, and their approval was not required in order for the consolidation to occur.

5. Tax Treatment of Financial Asset Securitization Investment Trusts (H.R. 2065)

Administration Position. **Do not support.** The Administration generally supports efforts to remove barriers to the efficient operation of the secondary market for receivables. Current law provides more favorable treatment for securitization of mortgages than for offerings backed by non-mortgage receivables. Mortgages received special treatment in 1986. Since 1986, the non-mortgage asset-backed securities market has grown substantially.

The FASIT proposal, however, presents significant problems regarding complexity, "phantom income," and overall revenue loss. The proposal's flexibility (e.g., the ability of the entity to issue debt at any time and to issue multiple classes of equity) creates the potential for income to completely escape taxation. Moreover, the proposal's complexity raises serious concerns regarding the Internal Revenue Service's ("IRS") ability to administer this area and of the ability of taxpayers to comply

with the rules. The Administration is working with interested parties and Congress to create a simplified structure which would reduce the potential for abuse, while allowing the necessary flexibility.

6. Deductibility of Bad Debt Losses of Nonbank Lending Institutions

Administration Position. Oppose. The rules concerning bad debts of federally regulated financial institutions recognize their special status which is not shared by non-federally regulated institutions. There are no assurances in the case of unregulated lenders that the debts will be worthless under general tax principles when charged off for book purposes, or that uniform charge-off standards will be applied. In addition, the absence of federal regulatory oversight provides unacceptable opportunities for distortions, particularly in the form of accelerated charge-offs.

Smaller, privately-held lenders not covered by the proposal would be disadvantaged relative to their larger, publicly-held competitors covered by the proposal.

C. INSURANCE PROVISIONS

1. Small Life Insurance Company Provisions

(a). Treatment of Small Life Insurance Companies Under the Alternative Minimum Tax

Administration Position. Oppose. The alternative minimum tax ("AMT") was designed to limit the extent to which taxpayers with economic income could use special deductions and credits to reduce tax liabilities. Allowing the small company deduction to be used to reduce adjusted current earnings would conflict with the purpose of the AMT. The legislative history to the Tax Reform Act of 1986 specifically addresses the treatment of the deduction for AMT purposes.

(b). Treatment of Policy Acquisition Expenses of Small Insurance Companies

Administration Position. Oppose. The adoption of rules that require capitalization of policy acquisition costs improved the measurement of economic income for all life insurance companies. Small companies currently qualify for relatively favorable acquisition cost treatment because a 5 year, rather than 10 year, amortization period is permitted (in addition to the tax advantage of the small life insurance company deduction). No policy justification exists for rules that provide certain small

life insurance companies additional cost advantages over their competitors.

(c). Capitalization of Policy Acquisition Expenses for Small Life Insurance Companies

Administration Position. Oppose. Adoption of the rules that require policy acquisition costs to be capitalized rather than expensed improved the measurement of economic income for all insurance companies. There is no justification for assuming a lower rate of policy acquisition costs for small companies. Small life insurance companies already qualify for relatively favorable acquisition expense treatment (as defined by the level of policy acquisition expenses) because acquisition costs are amortized over 60 months, rather than the general 120 month period. There is no policy justification for rules which would provide small life insurance companies with additional tax advantages over their competitors.

2. Treatment of Certain Personal Injury Liability Assignments (H.R. 1416)

Administration Position. Do not oppose. There appears to be no policy justification, apart from revenue considerations, for allowing less favorable tax treatment for work-related physical injury claims than other physical injury claims.

3. Treatment of Foreign Insurance Companies

Administration Position. Do not oppose, if made applicable on a prospective basis. While the provisions of current law do not violate our treaty obligations, we believe the proposed amendments could improve the operation of the statute.

4. Treatment of Certain Pension Business With Respect to Employees of Charitable Organizations

Administration Position. Oppose. The choice of operating as a for-profit business should carry with it the consequence of being subjected to Federal taxation. The proposal would allow a single taxpayer, Mutual of America, to pursue profits for the benefit of private interests, yet not pay its full share of income tax during the 5-year phaseout period. As a result the proposal would grant Mutual of America a competitive advantage in the market for pension plan administration.

5. Treatment of Certain Capital Gains and Losses of a Life Insurance Company

Administration Position. Do not support. Although life insurance companies do not get the benefit of section 1231 for depreciable property used in connection with a non-insurance business, this is one of many features of the taxation of life insurance companies that do not conform to the taxation of non-insurance businesses. Any change in the taxation of life insurance companies must be considered in connection with the overall scheme of life insurance company taxation.

D. PASS-THROUGH ENTITIES

1. Treatment of Certain Large Partnerships Under the Passive Loss Rules

Administration position. Do not oppose. Application of section 469(k) to large partnerships may facilitate simplified reporting of partnership losses and eliminate the need for partners to track accumulated passive losses.

2. Family S Corporations

Administration position. Do not support. If significant changes are to be made to the treatment of S corporations, proposals should be fashioned pursuant to a comprehensive, deliberate process, rather than on a piecemeal basis. This approach requires a careful consideration of the objectives of the S corporation regime, how those objectives can better be achieved and how any changes would interact with the other current forms of business organization such as limited partnerships and limited liability companies. The most recent comprehensive reform was enacted by the Subchapter S Revision Act of 1982. That legislation was preceded by detailed hearings on the problems facing S corporations and the objectives to be achieved in amending the rules. The Congress should follow a similar course today if it is to consider such comprehensive reforms.

3. Certain Trusts Eligible to Hold Stock in S Corporations

Administration position. Do not support. The Administration understands the objectives of allowing customary estate planning tools to be available in the case of a family-owned S corporation. However, if significant changes, such as this proposal, are to be made to the S corporation system, the proposals should be fashioned pursuant to a comprehensive, deliberate process, rather than on a piecemeal basis. This approach requires a careful consideration of the objectives of

the S corporation regime, how those objectives can better be achieved and how any changes would interact with the other current forms of business organization such as limited partnerships and limited liability companies. The most recent comprehensive reform was enacted by the Subchapter S Revision Act of 1982. That legislation was preceded by detailed hearings on the problems facing S corporations and the objectives to be achieved in amending the rules. The Congress should follow a similar course today if it is to consider such comprehensive reforms.

4. Modifications to S Corporation Provisions

Administration position. Do not support. If significant changes are to be made to the S corporation system, proposals should be fashioned pursuant to a comprehensive, deliberate process. This approach requires a careful consideration of the objectives of the S corporation regime, how those objectives can better be achieved and how any changes would interact with the other current forms of business organization such as limited partnerships and limited liability companies. The most recent comprehensive reform was enacted by the Subchapter S Revision Act of 1982. That legislation was preceded by detailed hearings on the problems facing S corporations and the objectives to be achieved in amending the rules. The Congress should follow a similar course today if it is to consider such comprehensive reforms.

5. Treatment of Safe-Harbor Leases of Membership Organizations

Administration Position. Oppose. This proposal to allow netting of interest income and rental expense from safe harbor leases applies to a select group of taxpayers and permits retroactive relief. It is the Administration's understanding that these transactions were structured with knowledge that there was a difficult tax issue regarding the application of section 277 to the transactions. In this circumstance, the issue of applicability of section 277 to safe harbor leasing should be left to judicial resolution.

E. COST RECOVERY PROVISIONS

1. Depreciation of Semi-conductor Manufacturing Equipment

Administration position. Do not support. Changes in depreciable life of particular categories of property should be made only after a detailed evaluation of the relevant economic and related facts and circumstances and review of satisfactory evidence that justifies a change. The Administration is not now aware of

information and analysis justifying a shorter 3-year recovery period for semi-conductors and is interested in obtaining additional relevant information. In consulting relevant factors, it has been suggested that depreciation benefits in other countries should be taken into account. However, U.S. depreciation lives should be determined by the economic life of assets. A separate depreciable life for each asset based on other nations' tax treatment of similar assets would be not be administrable and would not be sound tax policy.

2. Depreciation of Helicopters Used in Timber Management and Harvesting

Administration position. Do not support. Changes in depreciable life of particular categories of property should be made only after a detailed evaluation of the relevant economic and related facts and circumstances and review of satisfactory evidence that justifies a change. The Administration is not now aware of information and analysis justifying a shorter recovery period for helicopters used in timber harvesting. Moreover, a narrow proposed class is inconsistent with the basic structure of MACRS depreciation, which consists of broad categories of recovery periods to provide certainty and reduce administrative burdens.

3. Allow Passenger Vessels Used in Domestic Trade to Qualify for Merchant Marine Capital Construction Fund

Administration Position. Maritime issues are currently under review by the National Economic Council. The CCF program is one of the most generous tax subsidies in the Code since the economic value of the tax benefits arising from the CCF program exceeds the economic value of expensing acquired vessels. Consequently, extremely compelling arguments must be made to allow additional benefits.

Vessels operated in domestic trade already receive protection from foreign competition under the Jones Act. The Jones Act provides that all vessels operated in the coastwise trade or inland waterways must be U.S. owned, U.S. built, and U.S. flagged.

4. Treatment of Automobiles and Computers Under the Alternative Minimum Tax

(a). Computers

Administration position. Alternative minimum tax depreciation treatment is a subject of the Administration's budget proposals currently under consideration by Congress. Thus, we believe it

would be more appropriate to state the Administration's position on this proposal as part of the consideration of that legislation.

(b). Automobiles

Administration position. Alternative minimum tax depreciation treatment is a subject of the Administration's budget proposals currently under consideration by Congress. Thus, we believe it would be more appropriate to state the Administration's position on this proposal as part of the consideration of that legislation.

5. Increase Expensing for Passenger Automobiles

Administration position. Increased expensing is a subject of the Administration's budget proposals currently under consideration by Congress. Thus, we believe it would be more appropriate to state the Administration's position on this proposal as part of the consideration of that legislation.

6. Treatment of Leasehold Improvements to Nonresidential Real Property

Administration Position. **Oppose.** A principal reason for including leasehold improvements in the same recovery class as nonresidential real property was to simplify the Code and thereby eliminate disputes as to allocations of construction costs between assets that provide benefits only to the current tenant and longer-lived improvements. The proposal is of particular concern because it is quite broad. It applies to both lessors and lessees. Virtually any renovation of the interior of a building would qualify. Moreover, the proposal does not require rehabilitation to be relate to a specific lessee. Apparently, an entire rehabilitation of a building, other than the structural framework, would qualify.

F. EMPLOYEE BENEFITS

1. Taxation of Veterans' Benefits (H.R. 786)

Administration Position. **Support Administration's version of this legislation.** The Administration supports the objective of H.R. 786 and has submitted to Chairmen Rostenkowski and Moynihan a similar proposal to amend section 134 intended to achieve essentially the same result as H.R. 786. The Administration would prefer the Administration's legislative language (and explanatory committee report language).

2. Benefits of Retired Military Personnel Serving as Instructors in the Junior Reserve Officers' Training Corp (H.R. 736)

Administration Position. **Oppose.** Compensation paid by public and private secondary schools should not be treated as a qualified military benefit. These payments are in the nature of compensation includable in income, regardless of whether a particular teacher or administrator has previously been a member of the military and is therefore particularly qualified for the Junior Reserve Officers' Training Corp (JROTC) program.

3. Nondiscrimination Rules Not to Apply to State Judicial Pension Plans

Administration Position. **Do not support.** Under current regulations, tax-qualified plans of governmental employers are deemed to satisfy the non-discrimination requirements, as amended by the Tax Reform Act of 1986 and subsequent legislation, for plan years beginning before January 1, 1996. The purpose of the delayed effective date under current regulations is to provide adequate time to develop appropriate rules for applying nondiscrimination requirements to plans of governmental employers. Although we expect that regulations issued for governmental plans will recognize the distinct characteristics of governmental employers, we do not believe that there is a legitimate tax policy reason to provide a total exemption from the nondiscrimination rules for any one class of employees.

4. Application of Basis Recovery Rules in the Case of a Refund Feature

Administration Position: **Support.** This proposal would correct a technical problem in section 72 that, in some cases, precludes full basis recovery by annuitants.

5. Treat ESOPs as Charitable Organizations for Purposes of Transferring Stock in a Closely Held Corporation (H.R. 1807)

Administration Position. **Oppose.** We do not believe that the current charitable estate tax deduction for charitable remainder trusts should be expanded to cover ESOPs.

6. Excise tax on Nondeductible Contributions

Administration Position. The Administration generally supports the goals of the proposal. The problems that the proposal attempts to address are legitimate. A solution that balances the

competing interests of maximizing contributions to underfunded pension plans without allowing some employers to shelter excessive amounts of income is appropriate. We believe that the proposal represents a reasonable effort to balance those interests. We note, however, that the proposal is not necessarily the only way to address the problem and that this issue would be better considered in the broader context of comprehensive legislation relating to the funding of plans guaranteed by the Pension Benefit Guaranty Corporation. The Administration has formed an interagency working group on PBGC issues and intends to propose legislation in the near future.

7. Leased Employees

Administration Position. **Oppose.** The safe harbor alternative would permit service recipients and leasing organizations to circumvent the existing safe harbor limit on the percentage of leased employees. This limit protects nonhighly compensated employees by preventing avoidance of the nondiscrimination rules. In addition, in a sector of the labor force characterized by high turnover, the proposed five-year graded vesting is likely to result in reduced benefits for rank-and-file employees who remain employed with leasing organizations for a relatively short time.

8. Deferred Compensation Plans for Volunteer Fire and Rescue Personnel

Administration Position. **Oppose.** The purpose of section 457 is to limit the amount of deferred compensation provided by tax-exempt and governmental employers. The proposal would effectively allow certain fire and rescue personnel to defer up to 100 percent of their compensation. There is no tax policy reason for distinguishing employees who perform these services from any other employees of tax-exempt or governmental employers.

9. "Qualified Football Coaches Plan Technical Corrections Act of 1993" (H.R. 1981)

Administration Position. **Do not support.** The Administration has concerns about permitting this tax-exempt organization to maintain a 401(k) plan that was established after the general grandfather deadline for tax-exempt organizations, that covers individuals who are not its employees, and whose employers could permit them to make salary reduction elective deferrals under 403(b) tax-sheltered annuities.

10. Family and Medical Leave Accounts

Administration Position. **Oppose.** The proposal would significantly expand the tax preference that is currently provided for savings plans. Because of the negative impact on revenue, we do not believe that such an expansion is appropriate at this time. In addition, the proposal does not impose any nondiscrimination test for contributions. It is also unclear whether it would be necessary that the account balance actually be used for family and medical leave. We believe that Family and Medical Leave Account plans could reduce employers' incentives to sponsor traditional employee savings plans that provide greater benefits to lower-paid employees.

G. INDIVIDUAL INCOME TAX PROVISIONS

1. Prohibition of Fees Assessed on Employees Who Elect to Receive the Earned Income Tax Credit on an Advanced Basis

Administration Position. **Support.** The advance payment option is available so that recipients of the earned income tax credit may obtain the benefit of the credit over the course of the year, rather than in a lump sum at the time they file their tax returns. Allowing employers to charge a fee would be inconsistent with the Administration's goal of providing the maximum amount of this form of income support to low-income workers.

2. Require Employers to Include Earned Income Tax Credit Information with Annual Wage (W-2) Statement

Administration Position. **Support.** The Administration believes that this provision will encourage more low-income workers who are eligible for the earned income tax credit to claim the credit.

3. Enhanced Awareness of Advance Payment Option of Earned Income Tax Credit

Administration Position. **Oppose,** if the proposal would require the IRS to send individuals the Earned Income Credit Advance Payment Certificate (W-5). Individuals who receive this form from the IRS may feel obligated to fill it out, even if they do not want the advance payments. If the notification required by this proposal merely provides that the advance payment option is available and the IRS receives an appropriation to offset its administrative costs, we would not oppose this provision.

4. Modify Rule for Construction Workers' Deduction for Travel Expenses Paid or Incurred in Connection with Employment Lasting One Year or More

Administration Position. **Oppose.** It has not been established that the impact of the amendment of section 162(a) by the Energy Policy Act of 1992 upon the construction industry is unique or more burdensome than the impact upon other industries. Deduction of expenses for travel away from home may result in the deduction of personal expenses as business expenses. A universally applicable fixed time limit (as opposed to the rebuttable presumption of prior law) is appropriate and should minimize administrative disputes.

5. "Fairness for Adopting Families Act" (H.R. 930)

Administration Position. **Oppose.** While the Administration is extremely sympathetic to the needs of adoptive parents, this deduction should not be enacted at this time. A more restricted deduction limited to special needs adoptions would have greater justification.

6. Exclusion for Certain Overseas Allowances Received by Certain Department of Defense Personnel

Administration Position. **Do not oppose.** Allowing civilian employees of the Defense Department stationed overseas an exclusion comparable to the exclusion for employees of the State Department stationed overseas is reasonable.

7. Choice of 15% Credit or Deduction for Interest on Student Loans (H.R. 1667)

Administration Position. The Administration has proposed comprehensive reform of the student loan system, which is currently under consideration by Congress.

8. Defer Gains from Real Property Condemnations

Administration Position. **Oppose.** The proposed amendment to section 1033 is overly broad. Investment of the proceeds from condemned property in any other property within two years of the condemnation would permit inappropriate deferral of gain.

9. Deduction of State and Local Sewer and Water Fees

Administration Position. **Do not support.** Allowing a deduction

for State and local sewer and water fees would have a substantial revenue impact. Deductibility may also create disparities between taxpayers receiving these services from private utilities and those receiving similar services from governmental entities.

10. Extend Certain Benefits to Soldiers Serving in Somalia (H.R. 494)

Administration Position. **Do not support.** This proposal would preempt the Executive Branch's prerogative by providing "combat zone" tax benefits without the Executive Order contemplated in section 112(c). The Administration has developed and will support a proposal that extends the benefits of section 7508(a) to personnel serving in Somalia.

11. Charitable Deduction for Non-itemizers (H.R. 152)

Administration Position. **Oppose.** The revenue impact of this proposal would be substantial. In addition, the IRS lacks the resources to insure reasonable levels of compliance.

12. Allow Taxpayers Receiving Unemployment Compensation to Elect Federal Income Tax Withholding

Administration Position. **Do not oppose.** Recipients of unemployment compensation benefits may be subject to underpayment penalties because of their failure to pay tax on the benefits until they file their returns. Optional withholding would allow them to avoid this possibility. It should also alleviate collection problems for the IRS.

H. ESTATE AND GIFT PROVISIONS

1. Treatment of Retirement Benefits Under Community Property Laws

Administration Position. **Support with technical modifications.** The Administration generally supports legislation to clarify the availability of the marital deduction where the non-participant spouse in a community property state predeceases the participant spouse.

2. Treatment of Land Subject to Permanent Conservation Easement (H.R. 2031)

Administration Position. **Oppose.** We believe that the deduction allowed under current law for the grant of a charitable easement

is sufficient. The proposal would permit an exclusion for surrounding land of unlimited value from the gross estate, rather than the value of the charitable easement alone. The proposal would be subject to abuse and would substantially erode the tax base.

3. Estate Tax Valuation of Family-owned Media Businesses

Administration Position. Oppose. We are generally opposed to special valuation rules targeted to specific industries. Current law allows for the determination of appropriate estate tax values for these types of businesses and should not be changed in the manner proposed.

4. Increase Maximum Reduction Under Special Use Valuation Election (H.R. 1411)

Administration Position. Do not oppose. If Congress decides that the maximum of $750,000 by which the value of real property may be reduced under section 2032A is not sufficient, we would not oppose an appropriate increase in the context of otherwise acceptable legislation.

5. Tax Treatment of Certain Disclaimers

Administration Position. Oppose. The proposal would open up the statute of limitations for a one-year period. The United States Supreme Court is scheduled to decide this issue in the case of Irvine v. U.S. We believe that the issue should be resolved by the courts.

6. Estate Tax Recapture from Cash Leases of Specially Valued Property

Administration Position. Support. We support the proposal on a prospective basis only.

7. Estate Tax Marital Credit for Certain Employees of International Organizations (H.R. 770)

Administration Position. Support, with technical modifications. The Administration believes that the proposal is consistent with the United States' special role as host to international organizations.

I. FOREIGN TAX PROVISIONS

1. Treatment of Foreign Base Company Sales and Services Income of Controlled Foreign Corporations in the European Community

Administration Position. Oppose. Although the European Community is moving towards economic integration, the lack of direct tax harmonization creates inappropriate tax-planning opportunities.

2. Pass-through Treatment for Certain Dividends Paid by a Regulated Investment Company to Foreign Persons (H.R. 1891)

Administration Position. Do not oppose in part. We do not oppose the provisions of the bill that would treat RIC dividends as "interest-related dividends" to the extent attributable to interest income that would be exempt from U.S. tax if earned directly by a foreign person or as "short-term capital gain dividends" to the extent attributable to the excess of short-term capital gains over long-term capital losses. We also do not oppose the proposed treatment of RIC shares for estate tax purposes. We believe that these provisions will enhance the ability of U.S. mutual funds to attract foreign investors and eliminate needless complications now associated with the structuring of vehicles for foreign investment in U.S. securities. However, we oppose the provision that would treat RIC dividends as "taxable interest dividends" to the extent attributable to interest income that would be taxable if earned directly by a foreign person. This provision would unilaterally extend to foreign investors in U.S. RICs the benefits of the reduced withholding rates for interest provided in our income tax treaties, with no guarantee that comparable benefits will be provided for U.S. investors by our treaty partners.

3. Treatment of Software Licensing Income Earned by a Foreign Sales Corporation

Administration Position. At this time an inter-agency task force is reviewing our export program. It would be premature to propose any change in these rules at this time.

4. Expand Foreign Sales Corporation Exemption for Military Property

Administration Position. At this time an inter-agency task force is reviewing our export program. It would be premature to propose any change in these rules at this time.

5. Treatment of U.S. Bank Deposit Interest Received by Certain Netherlands Antilles Subsidiaries

Administration position. Oppose. There is no tax policy justification for treating as foreign source bank deposit interest that would otherwise be U.S. source.

6. Carryforward of Certain Pre-1987 Foreign Base Company Shipping Losses

Administration Position. At this time an inter-agency task force is reviewing our shipping program. It would be premature to propose any change in these rules at this time.

7. Deferral of U.S. U.S. Tax on Certain Reinvested Foreign Base Company Shipping Income

Administration Position. At this time an inter-agency task force is reviewing our shipping program. It would be premature to propose any change in these rules at this time.

8. Treatment of Certain Investments of Earnings of Controlled Foreign Corporations in U.S. Property

Administration Position. Oppose. We do not object to studying the proposed changes, as the House version of H.R. 2264 would require. However, we believe that it is important to consider the proposed exception carefully, to ensure that it does not undermine the general purposes of subpart F. We note, for instance, that the proposal does not simply treat loans to noncorporate and corporate U.S. persons identically. Unlike the current corporate provision, it appears that the proposal would provide an exception for loans made by a controlled foreign corporation to a noncorporate U.S. entity that is 25-percent or more owned by 10-percent U.S. shareholders of the controlled foreign corporation.

9. Election to Treat Controlled Contiguous Country Corporations as Domestic Corporations

Administration Position. Oppose. Section 1504(d) has no sound tax policy basis. Extension of section 1504(d) to all Canadian and Mexican subsidiaries would therefore not further a tax policy purpose and would effectively provide an election to claim losses incurred by those subsidiaries.

10. Revise Application of Interest Allocation Rules in the Case of Certain Financial Service Providers

Administration Position. **Do not oppose.** This provision recognizes the disadvantage suffered by diversified multinationals under the present interest allocation rules by virtue of the dramatic differences in leverage associated with financial and nonfinancial businesses. The provision raises, however, administrative concerns. The existing separate group rule is administrable, because it is limited to commercial and savings banks that are required by federal or state regulation to operate independently from any non-financial affiliates. If the separate group rule is expanded to include financial businesses that are not subject to a legal requirement of independent operation, anti-abuse rules will be necessary to prevent the transfer of funds between financial and non-financial affiliates through dividends, capital contributions, loans and other means. These rules would be difficult to administer.

11. Section 936 Treatment for Income from Investments in Certain South American Countries

Administration Position. **Oppose.** Adding more countries to the list of eligible borrowers would unacceptably dilute the benefits of the program.

12. Allocation to U.S. Source Income of Deductions for Taxes Paid to State and Local Governments

Administration Position. **Oppose.** The Supreme Court has held that a state may tax foreign source income if the income has a sufficient nexus with taxpayer activities in the state. Mobil Oil Corp. v. Commissioner of Taxes, 445 U.S. 425 (1980). As a result, states can and do tax income that is treated as foreign source for federal income tax purposes (e.g., foreign source dividends, income from export sales). When a state tax is imposed on foreign source income, it is related, and thus allocable, to foreign source income under the provisions of the Code and Treasury regulations governing allocation of state tax payments. These allocation rules are tax accounting rules that permit an accurate determination of US and foreign source income by matching expenses to the income to which they relate. The expense allocation rules should not be used to subsidize taxpayers' earning of foreign source income.

13. Commodities Income of a Controlled Foreign Corporation

Administration Position. Oppose. The "substantially all" requirement should not be deleted from the statute, because it plays an important role in ensuring that the exception is limited, as intended, to taxpayers actively engaged in a commodities business.

14. Increase in Reporting Threshold for Stock Ownership of a Foreign Corporation

Administration Position. Do not oppose. Although the basic corporate information collected under section 6046 is valuable, raising the reporting threshold to 10 percent does not significantly jeopardize that interest and would ease the filing burden of U.S. shareholders holding minority interests. These persons may find it difficult to obtain the information that must be reported.

15. Exempt Certain Income of Foreign Financing and Credit Services Companies from the Rules Applicable to Passive Foreign Investment Companies ("PFIC")

Administration position. Oppose. This proposal raises major administrative problems. The PFIC provisions eliminate the benefit of deferral for U.S. persons investing in foreign investment funds. The current and proposed exceptions are intended to permit certain active businesses to retain deferral, to the extent that the income would not otherwise be picked up under subpart F. These are, however, very difficult lines to draw and we think that, with the addition of the proposed exceptions, the appropriate lines will have been drawn. Therefore, Treasury should not be given authority to create additional exceptions.

16. Extension of Period to Which Excess Foreign Taxes May be Carried

Administration Position. Do not support. There is no apparent reason for harmonizing the foreign tax credit carryover periods with the carryover periods for NOLs. These provisions serve two distinct purposes. While NOL carryover rules are designed to permit averaging of income and loss over several years, the credit carryover rules were intended to mitigate timing differences between U.S. and foreign laws. The section 904 "baskets" were designed to foreclose averaging of high- and low-taxed income. On the other hand, harmonizing the carryback rules is sensible from an administrative prospective and should be

considered in connection with the simplification of the foreign tax provisions.

J. NATURAL RESOURCES PROVISIONS

1. Timber Provisions (H.R. 1997)

(a). Reduce Capital Gains on Timber for Domestic Processing

Administration Position. Oppose. Creating a capital gains indexation regime on an ad hoc, partial basis would be unfair and could result in unjustified tax benefits. It is more appropriate to consider these proposals after Congress completes its work on the deficit reduction legislation.

(b). Amend Certain Provisions Relating to the Export of Unprocessed Timber

Administration Position. A provision relating to the export of unprocessed timber is a subject of the budget reconciliation proposals currently under consideration by Congress. Thus, we believe it would be more appropriate to state the Administration's position on this proposal as part of the consideration of that legislation.

2. Repeal Related-party Sales Requirement for Nonconventional Fuels Production Credit

Administration position. Do not oppose. There is no compelling reason to limit the section 29 credit to situations where gas is sold to an unrelated person. The purpose of the credit is satisfied and there is little potential for abuse because the selling price is not relevant to the credit amount.

3. Tax Credit for Oil and Gas Produced from Marginal Properties

Administration Position. Oppose. Marginal properties were provided substantial tax advantages in recent tax legislation. We have seen no evidence that tax liability is currently acting as a barrier to production on these properties. Moreover, there is no reason that marginal production credits should be subject to more favorable treatment for AMT purposes than other tax credits. Use of credits against AMT liability is contrary to the purpose of the AMT to assure that taxpayers with economic income are subject to tax.

4. Determination of Independent Oil and Gas Producer Status

Proposal #1. Allow the per day barrel limitation to be computed on an average annual basis, rather than a per day basis.

Administration position. Support. A maximum level of refined oil should be computed on an annual basis.

Proposal #2. Increase the per day limitation to either 75,000 barrels or 100,000 barrels, presumably in conjunction with proposal #1 above.

Administration position. Oppose. The current 50,000 barrels of production threshold was carefully considered. There is no tax policy reason for adjusting the threshold.

Proposal #3. Allow regulated public utilities who sell gas to ignore sales of gas to customers in determining independent producer status.

Administration position. Oppose. Producers that are sufficiently integrated to sell at retail are probably large companies of the type intended to be excluded from percentage depletion. Regulated public utilities, which tend to be relatively large companies, should not be given a favorable rule for purposes of determining whether they qualify as independent producers.

5. "The Renewables and Energy Efficiency Incentives Act of 1993" (H.R. 2026)

Administration position. The Energy Policy Act of 1992 represented a careful consideration of many of the issues raised by the proposals in H.R. 2026. Moreover, many of the other proposals are the subject of the energy tax proposals included in the current budget legislation. Thus, we believe it would be more appropriate to state the Administration's positions on these proposals as part of the consideration of that legislation.

6. Permit Energy Credits to Offset Alternative Minimum Tax

Administration position. Oppose. There is no reason that energy credits should be subject to substantially more favorable treatment than other tax credits. In addition, the purpose of the AMT, to assure that taxpayers with economic income are subject to tax, will be weakened if credits may be fully utilized against it.

7. Treatment of Certain Timber Activities Under the Passive Loss Rules (H.R. 960)

Administration Position. After the Forest Conference President Clinton directed the Cabinet to develop a comprehensive and balanced solution to timber-related economic and environmental issues. A change in the tax law at this time would be premature. As a result of the limited management services to be provided with respect to small, family-owned timber farms, the 100 hour material participation requirement in some cases may result in treatment of these businesses as passive activities. However, the proposal is overbroad in at least two respects. The justification for exempting these businesses from the regulatory requirements is not apparent if non-family members provide more hours of management services than family members or the farms are not in fact small.

8. Exclusion from Income of Utility Energy Conservation Subsidies

Administration position. Oppose. Retroactive application of the exclusion from gross income provided in the Energy Policy Act of 1992 will not serve its intended purpose of encouraging conservation subsidies by utilities.

K. HOUSING TAX PROVISIONS

The low-income housing tax credit ("LIHTC"), since its enactment in 1986, has grown significantly more complex, to the point that it is one of the longest provisions in the Code. The Administration believes that it is not in the best interest of taxpayers or the government to further complicate these provisions. Consequently, it may be appropriate to review the low-income housing tax provisions with a view toward making these rules simpler and more administrable.

1. Low-Income Housing Tax Credit -- Tenant Protection

Administration Position. This proposal is currently included in the Senate Finance Committee's budget reconciliation bill. Thus, we believe it would be more appropriate to state the Administration's position on this proposal as part of the consideration of that legislation.

2. Low-Income Housing Tax Credit -- Community Service Areas

Administration Position. Do not support. The LIHTC is a credit for housing and functionally related facilities. Under this proposal, community service buildings would qualify for the credit if they are "predominantly" used by tenants. This might allow as much as 49 percent of the use to be for persons other than residents.

3. Low-Income Housing Tax Credit -- Rent Skewing

Administration Position. This proposal is currently included in the Senate Finance Committee's budget reconciliation bill. Thus, we believe it would be more appropriate to state the Administration's position on this proposal as part of the consideration of that legislation.

4. Low-Income Housing Tax Credit -- State Credit Authority Limitation: Stacking Rule

Administration Position. Do not support. This change would effectively allow States to carryover unused authority for an unlimited period. Although this change should have little revenue impact, it could significantly reduce the flow of credits to the national pool. This could result in an inefficient use of the credit by benefiting States that could not use all of their credit authority at the expense of the States that did use all of their credit authority.

5. Low-Income Housing Tax Credit -- Projects Financed by Tax -Exempt Bonds

Administration Position. Oppose. This proposal could increase the federal benefits to developers of these projects beyond the amount necessary as a subsidy.

6. Low-Income Housing Tax Credit -- Qualified Census Tracts and Difficult Development Areas

Administration Position. Oppose. This change would have a significant revenue cost. The designation of an area as difficult to develop results in a significant increase in the amount of the federal subsidy provided to projects developed in those areas. Because the designation standards contained in the proposal are not completely objective it is important that a federal agency continue to oversee the designation of these

areas.

7. Low-Income Housing Tax Credit -- State Credit Authority Limitation: De Minimis Rule

Administration Position. Oppose. The proposal lacks objective standards. The lack of uniform criteria for determining costs could make this proposal difficult to administer and enforce.

8. Low-Income Housing Tax Credit -- Project Eligible for Rehabilitation Credit Even if Interior Walls not Preserved

Administration Position. Oppose. This change removes one of the significant limitations on the availability of the rehabilitation credit. In effect, this change would merely increase the tax benefits available for a narrow class of low-income housing tax credit projects. If the tax benefits for low income housing are determined to be insufficient, a more direct approach to increasing those benefits should be taken.

9. Low-Income Housing Tax Credit -- Rehabilitation Credit Income Limit Not to Apply To Certain Low-Income Housing Projects

Administration Position. Oppose. The proposal would substantially expand the existing exception to the passive loss rules for the rehabilitation credit. The proposed expansion would principally benefit high-income individuals and would undermine the passive activity loss rules enacted as part of the Tax Reform Act of 1986.

10. Low-Income Housing Tax Credit -- Tenant Occupancy Requirement

Administration Position. Oppose. The credit already provides a substantial subsidy to encourage developers to provide housing to individuals and families with low-incomes (i.e., those below 50 or 60 percent of median income). Because this proposal permits a credit to be taken on units occupied by tenants whose incomes exceed the current income thresholds, this proposal could reduce the number of units available to tenants who qualify as low-income tenants under present law. If it is desirable to have the LIHTC benefit people with even lower incomes, a more comprehensive proposal should be considered.

11. Low-Income Housing Tax Credit -- Student Housing

Administration Position. This proposal is currently included in the Senate Finance Committee's budget reconciliation bill. Thus, we believe it would be more appropriate to state the Administration's position on this proposal as part of the consideration of that legislation.

12. Low-Income Housing Tax Credit -- Tenant Occupancy Requirement: De minimis Errors

Administration Position. This proposal is currently included in the Senate Finance Committee's budget reconciliation bill. Thus, we believe it would be more appropriate to state the Administration's position on this proposal as part of the consideration of that legislation.

13. Low-Income Housing Tax Credit -- Tenant Occupancy Requirement: Annual Recertification

Administration Position. This proposal is currently included in the Senate Finance Committee's budget reconciliation bill. Thus, we believe it would be more appropriate to state the Administration's position on this proposal as part of the consideration of that legislation.

14. Low-Income Housing Tax Credit -- Credits in the Year of Disposition

Administration Position. Do not oppose. For the portion of the year up to the date on which the project is sold, the seller has provided low-income housing and should receive the credit through that date.

15. Low-Income Housing Tax Credit -- Allocation Between Buyer and Seller (exact days/mid-month convention)

Administration Position. This proposal is currently included in the Senate Finance Committee's budget reconciliation bill. Thus, we believe it would be more appropriate to state the Administration's position on this proposal as part of the consideration of that legislation.

16. Low-Income Housing Tax Credit -- Treasury Authority to Waive Requirements Regarding Third-party Verification

Administration Position. This proposal is currently included in the Senate Finance Committee's budget reconciliation bill. Thus, we believe it would be more appropriate to state the Administration's position on this proposal as part of the consideration of that legislation.

17. Treatment of Certain Housing Cooperatives

Administration Position. Do not support. Although it may be appropriate to treat income from parking and laundry facilities (attributable to use by tenant-stockholders and their guests) as patronage sourced, interest on reserves and rental income should not be patronage sourced.

18. Treatment of Rehabilitation Tax Credit with respect to Certain Central Business Districts Under the Passive Loss Rules

Administration Position. See response to number 20, below.

19. Treatment of Rehabilitation Tax Credit Under the Passive Loss Rules (H.R. 1406)

Administration Position. See response to number 20, below.

20. Modification of Rehabilitation Tax Credit Limits Under the Passive Loss Rules

Administration Position. Oppose. Proposals 18, 19 and 20 would substantially expand the existing exception to the passive loss rules for the rehabilitation credit. The proposed expansion would principally benefit high-income individuals and would undermine the passive activity loss rules enacted as part of the Tax Reform Act of 1986. In this regard, it is difficult to justify additional special treatment at this time for the rehabilitation credit as opposed to any other credit or deduction. Treasury estimates that H.R. 1406 would result in a revenue loss of about $1 billion during the FY 1994-98 budget period.

21. Treatment of Cooperatives Owning Only Land (H.R. 1418)

Administration Position. Do not oppose, if prospective. The Administration is not aware of any reason why land cooperatives should not be entitled to the same treatment as housing cooperatives. However, the retroactive effective date (to December 31, 1987) is not appropriate.

22. Decrease Recovery Period to 15 Years for Certain Low-Income Housing Property and Provide Other Special Rules

Administration Position. Oppose. Generous tax advantages, including substantial credits and relief from the passive loss rules, already exist for low-income housing and rehabilitation. Shortening the depreciable life to 15 years, doubling the exception to the passive loss rules (from $25,000 to $50,000), eliminating the income phaseout for the exception to the passive loss rules, and reducing the depreciable life for AMT purposes (from 40 to 15 years) are not justified at this time. Moreover, these additional advantages would apparently apply to the entire project, not just the rehabilitation expenditures.

L. TAX-EXEMPT BOND PROVISIONS

At the present time, the Administration is in the process of reviewing the nation's infrastructure needs, including the extent to which tax-exempt bonds should be used to finance those needs. On completion of this review, it is possible that the Administration may offer proposals to amend the tax-exempt bond provisions of the Code to facilitate infrastructure financing.

1. Definition of Private Activity Bonds - Private Benefit Amount; Private Loan Exception For Housing Bonds

(a). Private Benefit Amount

Administration Position. Oppose. This proposal will have significant revenue costs. Further, this change would be a reversal of one of the two major changes to tax-exempt bond rules made by the Tax Reform Act of 1986. The benefit of tax-exempt financing should be limited to State and local governments. This change would result in a significant increase in the volume of tax-exempt bonds, with this increase being attributable to increased private benefit.

(b). Private Loan Exception for Housing Bonds

Administration Position. Oppose. The proposal would allow up to

10 percent of each issue to be used to make private loans that could not otherwise be financed on a tax-exempt basis. This change, in effect, could allow every general obligation issue to be increased in size to make loans for housing provided only that the loans are marginally subsidized.

2. Certain Cooperative Research Agreements

Administration Position. Oppose. The expansion of the basic research concept is likely to result in for-profit entities benefitting from the tax-exempt financing provided to 501(c)(3) organizations. Under the proposal, almost any research would qualify as "basic research" as long as no particular private entity is entitled to preferential use of any product of the research. Thus, tax-exempt bond financing would be available for a large portion of the capital cost of all research facilities. In addition, the change should not be made retroactively.

3. Certain Output Facilities (H.R. 1938)

Administration Position. Do not oppose. Although this change would have a slight revenue cost, it would simplify the tax laws and would mean that output facilities are subject to the same volume cap requirement as other bonds. There does not appear to be any reason to treat output facilities more harshly than other facilities. As a practical matter, the $15 million output limit of current law may have little effect other than to create an incentive for public power issuers to operate inefficiently.

4. Certain Volunteer Fire Departments (H.R. 219)

Administration Position. Do not oppose. This proposal to allow qualified volunteer fire departments to issue tax-exempt bonds for ambulances and other emergency response vehicles is a reasonable expansion of their limited authority to issue tax-exempt bonds under current law.

5. Spaceport Exempt Facility Bonds

Administration Position. Oppose. This proposal would principally benefit a single municipality in Florida. Further, there could be a significant revenue loss since these bonds would not be subject to the volume cap.

6. Qualified Mortgage Bonds - Home Improvement Loans; Two-Family Housing; Cooperative Housing

(a). Qualified home improvement loans

Administration Position. Do not support. It may be appropriate to review the dollar limitation on home improvement loans. However, this type of change should be considered in the context of a general review of the program.

(b). New two-family residences

Administration Position. Do not support. Residential projects with more than one dwelling should be subject to the rules and subsidy programs designed for multi-family housing.

(c). Cooperative housing

Administration Position. Do not support. In parts of the country where cooperatives are common, mortgage revenue bond financing may be effectively unavailable because of a variety of technical problems related to ownership through a cooperative. However, the proposal would make a variety of changes that, among other things, effectively increase the purchase price limit for cooperatives relative to other mortgage revenue bond financed projects.

7. Qualified Veterans' Mortgage Bonds

Administration Position. Do not support. The Qualified Veterans' Mortgage Bond program continues to apply to only five states as a grandfather rule and it is not appropriate to further expand the program in this manner. Veterans' programs should apply uniformly across the nation.

8. Qualified Small-Issue Bonds

Administration Position. Do not oppose, with clarification. The proposal to extend the one-year period to 90 days after enactment of the extension of the small issue bond program is a sensible change because the failure to extend the statutory sunset date has caused projects to fail to qualify for small issue bond financing. This change should only apply to facilities placed in service after June 30, 1991.

9. Modification of Rules Governing Qualified 501(c)(3) Bonds

Administration Position. Do not oppose. The primary effect of this proposal is to eliminate the $150 million cap on non-hospital bonds issued on behalf of tax-exempt organizations. Significantly, the $150 million cap generally applies only to large private universities. Large public universities and 501(c)(3) hospitals are not subject to similar restrictions. In addition, the technical rules associated with the $150 million cap have proven complex and difficult to administer. Repeal of the cap would simplify the tax-exempt bond financing rules applicable to tax-exempt universities, charities, hospitals and other 501(c)(3) organizations.

10. State Private Activity Bond Volume Limitation

Administration Position. Oppose. This provision would have a significant revenue cost because the reallocation of unused volume caps to States in need of volume cap is certain to result in the immediate issuance of additional tax-exempt bonds. Further, this change would eliminate a major rationale for the ability of States to carry over unused volume cap, which is the ability to save up cap for large projects. In addition, the administration of this program would result in a significant burden for the IRS.

11. Arbitrage Restrictions -- Six-month Expenditure Exception; State Revolving Funds

(a). 6-month exception

Administration Position. Do not support. Expansion of the rebate exception to pre-1990 bond issues may not be appropriate in all cases.

(b). Revolving funds

Administration Position. Oppose. The problems encountered by issuers in connection with State revolving fund programs can be avoided if issuers carefully account for bond proceeds. The proposal would have a much broader impact than merely addressing the perceived problem and could lead to abuse.

12. Certain Proposals Relating to the Tax Reform Act of 1986

(a). Peabody Place

Administration Position. Oppose. This proposal would permit up to $140 million of tax-exempt private activity bonds to be issued in a manner that does not satisfy current law, including the volume cap on private activity bonds. This proposal will effectively benefit only one taxpayer. Moreover, the project would benefit from an "in progress" transitional rule even though the bonds will not have been issued until 12 years after the related tax law change.

(b). Kenosha, Wisconsin

Administration Position. Oppose. Under the proposal, Kenosha would be permitted to continue to rely on a transitional rule that expired in 1990. The change would have an adverse revenue impact and would permit the issuance of bonds that do not comply with a number of current law limitations.

(c). Stanford University

Administration Position. Oppose. The transition rules to the 1986 Act were designed for specific projects that were already "in progress" at the time of the 1986 Act. Shifting the proceeds of a transitioned issue to a new use is inconsistent with the purpose of the transitional rules and is designed to avoid the limitations in current law on large section 501(c)(3) institutions.

13. Expand Exception to Pro Rata Disallowance of Bank Interest Expense Related to Investment in Tax-exempt Bonds; Increase Issues Level Exception; Modify Application of 501(c)(3) Borrowers

(a). Increase small issuer exception

Administration Position. Do not oppose. The justification for a small issuer exception to the bank deductibility rules is legitimate, and a reasonable case can be made that $10 million limit should be adjusted upward.

(b). 501(c)(3) bonds

Administration Position. Oppose. This proposal would have a significant revenue cost. This change effectively increases the $10 million small issuer limit by removing a significant category of bonds from its coverage. In addition, by providing every 501(c)(3) organization with its own annual $5 million limit, the applicability and complexity of the small issuer rule would be increased substantially.

14. Certain Airport, Dock and Wharf Facilities

Administration Position. **Oppose.** This proposal would greatly expand the types of privately used and owned property at airports and docks qualifying for tax-exempt financing without subjecting those bonds to the volume cap. Further, the proposal is vague in its description of the type of property that would qualify as transportation facilities.

M. COMPLIANCE

1. Accounting for Charges by Real Estate Reporting Persons for Costs of Complying with Reporting Requirements of Code section 6045

Administration Position. **Support.** The Administration believes that the proposal merely restates current law. However, there is some concern that the Committee's action could create an inference that the proposal is a change to current law. The Committee may wish to include appropriate "no inference" language in the effective date of the provision.

2. Direct Deposit of Tax Refunds

Administration Position. **Oppose.** This proposal is not administrable at the present time. IRS system capabilities cannot now assure correct processing of the necessary account information, so that individual A's refund does not end up in the account of individual B. Moreover, the IRS would incur substantial costs in manually transcribing the necessary account information, and this process would not be error free.

Direct deposit is feasible for refunds from electronically filed returns. The Committee should consider expansion of the electronic filing program, with appropriate modifications, if it wishes to make direct deposit more widely available.

N. EXCISE TAX PROVISIONS

1. Harbor Maintenance Trust Fund Expenditure

(a). Suspend Harbor Maintenance Tax When Harbor Maintenance Trust Fund Exceeds a Specified Balance

Administration Position. **Oppose.** The Administration has concerns that, depending on the means of implementation, a cut-off could be disruptive. The Administration also believes that

any concerns over excess balances in the Harbor Maintenance Trust Fund would be ameliorated by the proposal described in (b) below.

(b). Use of Harbor Maintenance Trust Fund for Certain NOAA Expenditures (H.R. 2094)

Administration position. Support if modified. A similar proposal was contained in the Administration's budget. The Administration would be concerned about any changes that differ significantly from the budget proposal.

2. Phaseout of Special Alcohol Occupational Excise Taxes

Administration Position. Oppose. The proposal would result in substantial revenue losses.

3. Exemption from Retail Excise Tax for Truck Equipment Used to Mix Explosive Chemicals (H.R. 1929)

Administration Position. Oppose. Equipment used to process, prepare, or load explosive products is currently exempt from tax under Treasury regulations. The additional exemption for containers used to transport components of explosive products is inconsistent with the general principle of taxing truck bodies that are reasonably suitable for use as part of a vehicle designed to transport a load over public highways. Moreover, the retroactive date is inappropriate because it rewards noncompliant taxpayers and penalizes taxpayers who complied with existing law.

4. Limit on Transfers of Motorboat Fuels Tax Revenues to the Boat Safety Account

Administration Position. Support. The Administration has proposed this in the Coast Guard reauthorization legislation.

5. Consolidate the Tax on Aviation Gasoline at One Point of Collection

Administration Position. The taxation of fuels and collection points for such taxes are addressed by the Administration's budget proposals currently under consideration by Congress. Thus, we believe it would be more appropriate to state the Administration's position on this proposal as part of the consideration of that legislation.

6. Wine Spirits -- Permit Whey, Tomatoes and other Agricultural Products

Administration Position. **Do not oppose, with clarifications.** Under the proposal, the definition of wine spirits would be expanded to include spirits derived from agricultural wine (i.e., wine made from agricultural products other than fruit) and other than standard wine. Thus, nonstandard wine that is currently wasted could be used to make wine spirits to fortify nonstandard wines such as wine coolers. The proposal should be clarified to provide that wine spirits made from other than standard wine may not be used to fortify natural wine.

7. Dedicate 1 cent Per Gallon of Tax on Diesel Fuel Used by Railroads to a Newly Created Railway Trust Fund

Administration Position. The proposal relates to the Administration's budget proposals currently under consideration by Congress. Thus, we believe it would be more appropriate to state the Administration's position on this proposal as part of the consideration of that legislation.

O. OTHER PROVISIONS

1. Tax Credits for Indian Investments and Employment (H.R. 1325)

Administration Position. The creation of tax incentives for economically distressed areas, including Indian reservations that are economically distressed, is addressed in the Administration's budget proposals currently under consideration by Congress. Thus, we believe it would be more appropriate to state the Administration's position on this proposal as part of the consideration of that legislation.

2. Alaska Native Corporations Standing with respect to Sales of Losses

Administration Position. **Do not oppose.** Relief to Alaska Native Corporations ("ANCs") should be structured to minimize administrative burdens on the IRS and the potential for the assertion of collateral estoppel against the government.

3. Tax Credit For Contributions to Certain Research Consortia

Administration Position. Extension and modification of the research and experimentation credit are addressed by of the

Administration's budget proposals currently under consideration by Congress. Thus, we believe it would be more appropriate to state the Administration's position on this proposal as part of the consideration of that legislation.

4. Enhance Deduction for Contributions of Computer Equipment to Arts Institutions

Administration Position. Oppose. The special rule for contributions of scientific property for research was enacted in response to studies that showed that universities were unable to meet the rising costs of scientific equipment in such equipment-intensive research areas as physics, chemistry and electrical engineering. This rationale does not apply to contributions of equipment for use in design research. Moreover, there is no evidence that the costs of the equipment used in design research are rising. In fact, the cost of computer equipment, one of the principal tools of design research, is generally falling.

5. Extend the Exception For Debt-Financed Investments in Real Property to Certain Private Foundations

Administration Position. The treatment of exempt organizations' real estate investments is addressed by the Administration's budget proposals currently under consideration by Congress. Thus, we believe it would be more appropriate to state the Administration's position on this proposal as part of the consideration of that legislation.

6. Treatment Under the Passive Loss Rules of Closely Held C Corporations Engaged in Equipment Leasing

Administration Position. Oppose. There is no justification for making a special exception to the passive activity rules for closely-held C corporations engaged in equipment leasing so that passive activity losses could offset, for example, portfolio income.

7. Treatment Under the At-Risk Rules of Real Property Acquired by Foreclosure

Administration Position. Oppose. One of the principal purposes of the at-risk rules is to limit the opportunity to claim inflated deductions by overvaluing property. Unrestricted nonrecourse seller-financing would encourage overvaluation of the property to which it relates. The proposal does not include explicit safe-

guards to prevent such overvaluation. The proposal neither requires an appraisal nor limits the purchaser's at-risk amount to the property's appraised value.

8. Repeal Limitation on Farm Losses Under the Alternative Minimum Tax

Administration Position. Do not oppose. The alternative minimum tax (AMT) rules can deny a general partner in a farm syndicate who is actively managing the farming activity, any deduction for economic losses from the activity. Because of his active management, his losses would not be disallowed under the passive loss rules. However, section 58(a) would result in a disallowance of these losses for AMT purposes even though he is an active participant in the farming activities. The repeal of section 58(a) would result in conformity between regular tax and AMT purposes for these losses. The repeal of section 58(a) could result in a benefit for a small number of taxpayers.

9. Extend "Placed-in-Service" Date for Project under Section 204(a)(1)(E) of the Tax Reform Act of 1986

Administration position. Oppose. The debates regarding the complex and extensive effective date provisions and special rules relating to the Tax Reform Act of 1986 should not be reopened.

10. Exempt or Expand Safe Harbor from Accumulated Earnings Tax for Widely-Held Corporations

Administration's Position. Do not support. Creation of exceptions to the accumulated earnings tax ("AET") rules must be carefully considered, particularly with respect to their coordination with other anti-avoidance provisions in the Code, including the personal holding company and foreign personal holding company rules. Although changes in these rules may be justified, they should await a thorough review of these anti-avoidance provisions.

11. Definition of Start-Up Companies Under Research Credit

Administration Position. Extension and modification of the research and experimentation credit are addressed by the Administration's budget proposals currently under consideration by Congress. Thus, we believe it would be more appropriate to state the Administration's position on this proposal as part of the consideration of that legislation.

12. "The Environmental Remediation Tax Credit Act of 1993" (H.R. 2340)

Administration Position. Do not support. Although we fully support the goal of environmental cleanup, the proposal would be complex and difficult to administer. In addition, the proposal would have significant revenue cost, and would not be the most efficient means of providing subsidies to finance cleanup costs.

13. Social Security Tax Status of Distributors of Bakery Products

Administration Position. Do not support. Bakery drivers have been treated as statutory employees for employment tax purposes since 1951. We do not believe that there is sufficient reason for changing this longstanding provision and disrupting existing arrangements.

14. Application of Common Paymaster Rules to Certain Agency Accounts at State Universities

Administration position. Do not support. We believe that the proposal is unnecessary. Payments from more than one state agency account would not be treated as payments from separate legal entities for employment tax purposes. Thus, the common paymaster rule is not necessary because wages from each agency would be aggregated under current law for purposes of determining the extent to which wages exceed the FICA wage base.

15. Issuance of Certificate to the Social Security Trust Fund (H.R. 931)

Administration Position. The Administration's position is under development.

16. Exempt Non-affiliated Religiously Oriented Schools from Coverage Under the Federal Unemployment Tax Act (FUTA)

Administration position. Do not support. We do not support this proposal because we do not believe that there is sufficient reason to reduce unemployment compensation coverage for this group of employers and their employees. In addition, an exception that is based on whether the employer has a "primary religious purpose" would increase administrative complexity in the statute.

**ADMINISTRATION POSITION ON
TAX ISSUES AFFECTING THE HEALTH AND SAFETY
OF INNER-CITY RESIDENTS
AND OTHER MISCELLANEOUS HEALTH-RELATED TAX ISSUES**

1. Excise Tax on Firearms

Administration Position. The Administration is examining whether an increase in the excise tax on firearms and ammunition is appropriate and, if so, whether the increase should apply to all firearms in the manner of the proposed tax or only to firearms and ammunition most commonly associated with gunshot wounds. In addition, we believe that medical cost containment should be addressed as part of a comprehensive health reform plan rather than through narrower approaches such as the Hospital Gunshot Cost Containment Trust Fund.

2. Excise Tax on Syringes and Intravenous Systems

Administration Position. The tax, by increasing the price of syringes and intravenous systems that do not meet new Federal safety standards, would eliminate or substantially reduce their use by health care providers. While the Administration agrees with the goal of ensuring the safety of syringes and intravenous systems, we are concerned about the administration of a relatively small tax that would be imposed at the retail level. Direct statutory or regulatory restrictions on sales of syringes and intravenous systems, with appropriate penalties, might be a more appropriate method of assuring public safety than the proposed tax.

3. Treatment of HMOs and Charitable Risk Pools under Section 502(m) of the Code

Administration Position.

(a). HMOs

Administration Position. The Administration is currently preparing a comprehensive health care reform package. Because of the significance of HMOs in the health care market, the issue of their tax treatment under section 501(m) should be addressed only in the context of consideration of the Administration's health care reform package.

(b). Charitable Risk Pools

Administration Position. The laws of at least one state apparently provide for the organization of charitable risk pools that provide insurance coverage to charitable organizations that are members of the pool. The treatment of these charitable risk pools under current law may be uncertain. In particular, it is unclear whether section 501(m) precludes these organizations from qualifying for tax exemption under section 501(c)(3).

The Administration would not oppose a provision under which a charitable risk pool could qualify as a section 501(c)(3) organization, notwithstanding section 501(m), provided that the charitable risk pool receives a sufficient amount of contributions from non-members that it uses to subsidize the coverage provided to members. The Administration believes that, in the absence of such subsidized coverage, the operations of a charitable risk pool would be virtually identical to a mutual insurance company, and as such should be subject to tax in accordance with the policies underlying section 501(m).

4. Inclusion of Organ Donor Information in Materials Sent to Taxpayers by the Department of Treasury

Administration Position. The inclusion of an organ donor card with every refund payment needs to be carefully considered. Currently, "stuffers" are only included with refund payments that do not include an error statement. Error statements explain that the taxpayer's refund is different from the amount claimed and that the difference will be explained in a subsequent mailing. Confusion by including additional material with the error statement should be avoided.

When this proposal was considered in the past, it has been noted that a number of religious groups find the concept of organ donation offensive and may object to receiving unsolicited materials regarding organ transplants from the government.

5. Rules Relating to Loss Reserve Discounting by Medical Malpractice Insurers

Administration Position. Property and casualty insurers are allowed a deduction for their loss reserves. Section 846 requires this deduction to be discounted to take into account the time value of money. The payment pattern of losses in each line of business is taken into account in computing a taxpayer's discounted loss reserves. The payment pattern of a line of business is generally based on industry-wide data. In certain

circumstances, however, a taxpayer may be able to use a payment pattern for a line of business based on its own historical experience.

Revenue Ruling 92-76, 1992-2 C.B. 453, allows a taxpayer to use its own historical loss payment pattern for a line of business if certain conditions are met.

An earlier revenue ruling had allowed certain taxpayers to elect to use "composite discount factors"--that is, factors based on data from several lines of business--in computing discounted loss reserves for medical malpractice and professional liability lines of business. Rev. Proc. 91-21, 1991-1 C.B. 525. Revenue Ruling 91-21 does not apply to accident years after the 1991 accident year.

The Administration would not support the use of composite discount factors in cases outside the scope of Revenue Ruling 91-21 for tax years 1992 and 1993. With respect to tax years 1994 and thereafter, medical malpractice issues might be relevant in the context of a review and discussion of comprehensive health care reform.

Chairman RANGEL. You did exclude from your objections to technical amendments. Was that in here at all? I know about rifle shots, revenue neutrality and simplifications.

Mr. SAMUELS. We are not commenting on issues that are purely technical corrections.

Chairman RANGEL. Are there any questions from members of the subcommittee? Mr. Hancock?

Mr. HANCOCK. Yes, I would like to ask a couple of questions about page 36, item 5 of your testimony. I am a little confused about the administration's position on this.

All it does is move the 1-cent tax on aviation gasoline currently collected at the retail level to the manufacturer's level, simplifying the collection process. The retailers support it, the manufacturers support it, and according to the Joint Tax Committee it will raise about $500,000 in 1994 and have no revenue effect thereafter.

Can you tell me if the administration supports or opposes this?

Mr. SAMUELS. Mr. Hancock, as you know the Senate is considering the reconciliation bill this week. The collection point issue is in that bill so we felt, as described in the testimony, that it was not appropriate at this point to comment because it is something that might be addressed in the legislative process. I would say, however, that our position of refraining from comment does not mean that we oppose this proposal. We are sympathetic to trying to improve collection of these types of tax and we believe that efforts can be made to improve collection and and our comments on this proposal do not mean that we oppose it.

Mr. HANCOCK. It seems to me that in a situation like this it would be very easy to make a decision and say this makes good sense. Everybody we have talked to seems to think so. You are saying that you don't oppose it. You just don't want to make a decision on it now?

Mr. SAMUELS. Correct.

Mr. HANCOCK. Thank you, Mr. Chairman.

Chairman RANGEL. Mr. Hoagland.

Mr. HOAGLAND. I note, Mr. Samuels, that on page 6 you discuss the treatment of financial assets securitization investment trusts. Mr. Shaw and I have introduced H.R. 2065, and you indicate in your statement that the administration generally supports efforts to remove the barriers to the efficient operation of the secondary market for receivables, and you go on to note that our FASIT proposal presents significant problems regarding complexity, phantom income and overall revenue loss, but it sounds like generally you do support the notion of FASIT legislation if we can reach an agreement on the language?

Mr. SAMUELS. Yes, sir. I believe that the administration supports the principle that we should try to make the capital markets as sufficient as possible without undue tax barriers, and so we would support this type of legislation. As the testimony indicates, we are concerned about the complexity issues that are associated with this particular proposal and look forward to working with interested parties and Congress in trying to fashion legislation that would be similar to the so-called REMIC legislation.

Mr. HOAGLAND. You all do feel that now is the time to pass legislation to facilitate a secondary market for nonmortgage obligations,

that we can get that done and reach an agreement as to the best way to approach that?

Mr. SAMUELS. Yes, we believe that this is the time to continue to work on this proposal. The secondary market for these types of obligations is quite large, and I think that it would be useful to the market to have a proposal like this developed.

Mr. HOAGLAND. It seems to me that creating liquidity in the small loan and receivables market is crucial if we hope to resolve the credit crunch and to encourage the origination of loans by lenders to America's small and medium businesses. Your staff, Mr. Samuels, has been very helpful in assisting my people in developing the FASIT legislation. Additionally, my people have been working with the Ways and Means and Joint Tax staffs to fine tune the FASIT legislation, including, as you noted, a reduction in the complexities of the legislation.

I have on this date forwarded, so you will know, to Joint Tax a second revenue request asking for a detailed breakdown which will allocate revenue losses to specific provisions of the FASIT legislation. Hopefully such a breakdown will facilitate our fine tuning of the FASIT legislation into a final product, and I want to let you know that I appreciate your work to date personally and that of your fine staff, and I look forward to working with you and with Treasury to that conclusion.

Mr. SAMUELS. Thank you, Mr. Hoagland. We look forward to working with you.

Mr. PAYNE. Mr. Chairman.

Chairman RANGEL. Mr. Payne.

Mr. PAYNE. Thank you, Mr. Chairman. Mr. Samuels, I noticed in your testimony that you said that the administration believes that all of the S corporation tax proposals should be carefully considered in the context of a comprehensive review of S corporation rules. Does that mean that the department of Treasury intends to conduct such a comprehensive review or is in the process of conducting one?

Mr. SAMUELS. Mr. Payne, I think when we have seen all these proposals, it strikes us that, given the interest in this area, it would be an appropriate time to start a review, and we are prepared to work with the interested parties and Congress in developing proposals that would be appropriate in today's circumstances. We have not yet started such a review. As you know, a bill was recently introduced with a whole series of proposed changes to the S corporation rules. We have looked at that bill and at the other miscellaneous proposals relating to S corporations. In analyzing those proposals it occurred to us that the appropriate way to deal with these issues would be to look at the whole area and not proceed on a piecemeal basis. I think, given the interest in the area and the growing importance of S corporations, that we would be prepared to start working with you and others to develop a view on this, and there should be hearings as there were in 1982 when the S corporations provisions were reevaluated.

Mr. PAYNE. I am pleased to hear of your interest and do look forward to working with you on that provision. I had one other question, Mr. Chairman, and it has to do with methodology. As you made decisions about supporting or opposing these various provi-

sions, were you looking specifically at tax policy or were you considering the overall public policy aspects of some of these provisions?

Mr. SAMUELS. We looked at both tax policy and other considerations. These provisions were considered by other parts of the administration to try to develop a consensus view.

Mr. PAYNE. I have a particular bill I have an interest in that you are opposing that has to do with the treatment of land subject to permanent conservation easement. Those of us who live in rural areas and have urban areas that are parts of our district believe that we are losing some of our open spaces at a substantial rate. We are looking at ways that we might be able to curb the rate of loss. That is good public policy. I think the bill really is an attempt to get at a good public policy objective. I would like to continue to work with the Treasury, noting the objections you have to see if there is not a way that we can structure the bill so that you would no longer oppose it.

I would appreciate the opportunity to work with you.

Mr. SAMUELS. We would be pleased to work with you. As our comments note, we were concerned about the broad nature of the proposal, and our preliminary revenue estimate on the proposal indicated that there would be a very substantial loss of revenues, and that was also a factor that we took into account in evaluating the proposal as presented.

Obviously, we would be pleased to work with you to see whether we could refine the proposal in some way that would not result in such a large revenue loss.

Mr. PAYNE. Well, we, too are looking at the revenue implications. This is a bill that was introduced last year. We have tried to define it more narrowly and were surprised to learn from the Joint Tax Committee that the revenue estimates have actually gone up by a factor of several times from the revenue estimate of last year in spite of the fact that we had narrowed the focus of the bill, and so we would like to continue to work with you on that as well. Thank you very much.

Mr. SAMUELS. Thank you.

Chairman RANGEL. Mr. Camp.

Mr. CAMP. Thank you, Mr. Chairman. Mr. Samuels, could you please tell me if I am correct in assuming that do not support is better than do not oppose, and if I am incorrect, could you define the difference between the two and the criteria that accounts for that difference?

Mr. SAMUELS. Well, we had an ordering of positions, and we took into account a variety of factors. As you know, with most of these tax policy decisions you have to weigh various factors. I would say that "do not support" is not as strong as "oppose," and reflects the fact that a particular proposal may have, in terms of the balancing, some significant merit, but there are also significant problems with the proposal. The "do not oppose" is something that we think has merit. There obviously, as I said with all these proposals, are pluses and minuses, and "do not oppose" is a standard one which we would feel from a tax policy and other considerations if it were passed we wouldn't feel incumbent to formally oppose it, so it is a kind of a negative blessing of some type. I think that is a way of describing it.

Mr. CAMP. So is "do not support" better than "do not oppose?"

Mr. SAMUELS. "Do not support" is worse. From our perspective is support, the best; is do not oppose second best, and is then do not support the next level, and then there is oppose?

Mr. CAMP. OK. Other than the brief comment you made——

Mr. SAMUELS. Let me just add, we felt that just saying support or oppose doesn't deal with the kind of gradations of judgments that go into this, and so we felt that there should be—and I think this has been following some tradition—some gradations between just support and oppose.

Mr. CAMP. It is the gradations and judgment I am interested in. Were there any objective criteria that you used to make those other than you said you looked on a case-by-case basis at the merits of each proposal? Was there anything other than that, anything——

Mr. SAMUELS. No, sir, we looked at each proposal on its own and evaluated each proposal on its own to determine what our position was.

Mr. CAMP. Thank you, Mr. Chairman.

Chairman RANGEL. Mr. Kopetski.

Mr. KOPETSKI. Thank you, Mr. Chairman. Mr. Samuels, I was pleased to see over on the Senate side that a number of the low-income housing credit issues were addressed in the Senate reconciliation bill, and I hope we can have your support in the conference committee on some of those areas that the Senate included in their version, and I hope we can work together on those issues. I do want to address some of the timber-related issues on page 23 and 25 and get a better understanding of the administration's position.

First, you oppose a capital gains indexation regime for growing timber, and then it says it is more appropriate to consider these proposals after Congress completes its work on the deficit reduction. Now, a part of the problem is that the Senate took the FSC or Foreign Sales Corporation moneys and spent them on budget deficit reduction. At any rate, a nontimber-related program which gets to B, which is where you say we believe it would be more appropriate to state the administration's position on this proposal as part of the consideration of that legislation, being the Senate side. I guess it would be very instructive for us to know the Treasury's position on that provision of the Senate bill as it relates to removing FSC for log exports.

Mr. SAMUELS. Mr. Kopetski, the revenue reconciliation bill is now in the Senate. There will obviously be some differences between the Senate and the House version, and the administration feels that we would like to defer any comments on those differences until conference. The Senate hasn't voted on their bill, and we haven't felt that it would be really useful to start taking positions about how we feel about particular provisions before the Senate acts, and we evaluate the whole bill and all the provisions of it and form a view about the conference.

Mr. KOPETSKI. Well, in addition to that piece of legislation, the President is about to announce his timber bill. He spent a full day in the Northwest with the Vice President trying to work out this complex, very emotionally charged issue, and so probably next week a bill is going to be sent to the Congress, and it is going to

include these measures as well, and I don't think you have the luxury of waiting for conference.

Mr. SAMUELS. Let me just say, I think that what we would like to do is wait until the Senate has acted, which we believe will be in the very near future. You are correct that the administration is actively working on this issue, and decisions are in the process of being reviewed. There is an active working group within the administration, and the administration's views will be made known when the President makes the decisions, and as far as I know he hasn't made decisions on these issues. But he is actively working on it, and I believe you are correct that the administration is going to announce its positions in the near future.

Mr. KOPETSKI. Well, let me ask you this: Perhaps you can help me here? There is an issue of whether capital gains treatment should be given to those who export logs as well as those who sell the logs for domestic mills. My position is that we should not make that distinction. Do you folks have a position on that issue?

Mr. SAMUELS. I think your question relates to, in effect, the export benefits available under the tax law for timber, including the unprocessed timber which is in the Senate bill, and I am sorry not to be able to answer you directly on that, but that again is——

Mr. KOPETSKI. That is a separate tax issue. There is currently-well, I don't want to lecture you on tax policy and Tax Code at this point. I will just say that we could end up, we in the Northwest could get whipsawed by the indecisiveness of the administration on this. We wait for conference and we lose our opportunity to effect policy for the Northwest in this bill. That is one of my concerns.

In addition, we could get into the whole politics of the timber bill and be told that we are going to deal with that in reconciliation, and we lose out entirely, so this is a huge concern of mine, the fact that the White House has not made up its mind on these very important issues for the Northwest.

Mr. Chairman, are we going to have a second round of questions? I know I am taking a lot of time.

Chairman RANGEL. I would say that we hope—you mean with this witness? I really don't know.

Mr. SAMUELS. We would be happy to——

Chairman RANGEL. We have a large number of witnesses. I am certain Treasury will be anxious to work with you and submit answers, but we are going to be here most of today.

Mr. KOPETSKI. Mr. Chairman, then I will stop at this point and work with them on the other questions that I had as well and other parts of the proposal.

Mr. SAMUELS. We would be happy to work with you and your staff on these questions.

Mr. KOPETSKI. Thank you, Mr. Chairman.

Chairman RANGEL. Mr. Hoagland.

Mr. HOAGLAND. Mr. Samuels, referring to page 5, item B–2 in your outline, I served on the Banking Committee for 4 years, and concluded during my service there that allowing banks to underwrite and sell mutual funds is an important way of strengthening the financial institution industry, and I notice here that the Treasury does not oppose what was section 623 of H.R. 13 to allow banks to convert common trust funds, transfer assets from common trust

funds into mutual funds, and it looks here as if you all don't oppose a provision that would allow smaller banks to participate in this activity by being able to transfer their common trust funds to one or more larger mutual funds. Do I read you correctly?

Mr. SAMUELS. Yes, sir.

Mr. HOAGLAND. Is that another issue we could work on together?

Mr. SAMUELS. We will be pleased to work on the technical parts of that proposal.

Mr. HOAGLAND. The banking industry is under assault in many, many areas, and anything we could do to strengthen our financial institutions I think would benefit the economy considerably.

Let me refer you to page 7, item B–6, "the deductibility of bad debt losses of nonbank lending institutions." Is there any hope for progress on this issue or do your words mean what they say?

Mr. SAMUELS. We have looked at this very carefully, and the reason that we came up with our position of opposition to the proposal is that we think that it would be very difficult to administer and establish standards which would be similar to bank regulatory standards, so we just don't see really how one can do that in a way that would provide for sensible administration over time.

Mr. HOAGLAND. So your opposition sounds pretty hard on that issue unless we can somehow justify these-address these concerns?

Mr. SAMUELS. That is correct.

Mr. HOAGLAND. Thank you, Mr. Chairman.

Chairman RANGEL. Mr. Kopetski, you had other questions?

Mr. KOPETSKI. Thank you, Mr. Chairman.

Mr. Samuels, in terms of the Vets bond program on page 32 of your document, Oregon and Texas and California, and I forget the other State, are these special programs that allow building of houses and that provide housing for veterans, the States have agreed to a cap? I don't know if you are aware of this, in terms of how much bond—how many bonds or the amount of bonds that they would issue. I don't know if you are aware of that? Perhaps we could work together on trying to see if we can't work something out in this area.

I know that there have been fears in the past. Congressman Moody had sponsored this bill before, and we are looking at ways to put a cap on this. Is it possible we might be able to work together on this?

Mr. SAMUELS. We would be happy to work with you on this. I think our concern on this particular proposal is that at the moment the program applies to five States, and has been subject to a grandfather rule under current legislation, where people felt that it was going to be phased out because it was targeted to only five States. In analyzing the proposal, it seemed to us that if one wants to make these types of benefits available, the programs should apply uniformly across the country so that it is not just available to veterans that happen to be in particular States. While we understand the benefits of this proposal, it seemed to us that, instead of perpetuating a program that only applied to five States and which was grandfathered, it would be more appropriate to expand the program on a nationwide basis.

Having said that, we are happy to discuss it.

Mr. KOPETSKI. Well, I think that—I guess I would respond by a couple of points. I believe New York is the fifth State. We are talking about probably 30 to 40 percent of the population of the United States, and so that is significant. It is not just one-tenth of the States.

Mr. SAMUELS. We understand. I think that our understanding is that the States are Texas, Oregon, California, Wisconsin, and Alaska.

Mr. KOPETSKI. And Alaska, I am sorry, it is not New York.

Mr. SAMUELS. We did consider that some of those States obviously have a significant population, but that when you looked at the entire country it was maybe more targeted than it should be, but as I say, we are pleased to discuss this with you.

Mr. KOPETSKI. It is my understanding that no other States are asking to create these kinds of—this particular program; that it is a way of providing housing to a lot of people in this country. Could I ask you also about the special occupation tax. Everybody from bed and breakfasts to major stores have to pay this tax, and this is after they pay their regular corporate taxes, after they pay taxes on the beer and wine sold, and then they get hit with this $250 tax.

Now, that is not a lot if you are Safeway, but if you are the mom and pop's bed and breakfast in Ashland, Oreg., providing—which is important to our tourism industry, and people seeing Shakespearean plays and that, $250 is a lot of money to these folks. Is this the only reason, it is just a revenue loss, the reason you oppose this?

Mr. SAMUELS. Yes, it is. Our revenue estimate is that it would lose $427 million over 5 years, and that seemed as if it was a significant number in today's deficit reduction period, and so that was the issue that we were concerned about.

Mr. KOPETSKI. In terms of policy, then, do you want to comment on whether this is fair tax policy for small businesses to be hit a third time, even if they offer for sale one glass of wine within the evening?

Mr. SAMUELS. I think from a policy point of view this is an excise tax, and it seemed to us that you have to weigh the amount collected, the administerability and kind of the compliance, and the compliance costs. It is essentially similar to a user fee. I don't think we have strong policy kinds of issues on either side of that.

Mr. KOPETSKI. Thank you. Thank you, Mr. Chairman.

Chairman RANGEL. Mr. Samuels, you mentioned some clarification that you wanted with the housing tax provision. Do you envision some package that you can support?

We are concerned that all the amendments we may consider may just have too many sweeteners in it, but do you have a well-balanced package, do you have something in mind when you are saying that you wanted to review the low-income housing tax provisions? Do you know what you want to do now? Or just look at them?

Mr. SAMUELS. The statement in our testimony reflects the same considerations as our comments on S corporations. We looked at these proposals, and there are a significant number of them, and we looked at the statute which is now one of the longest provisions

of the Internal Revenue Code, possibly the longest. I haven't counted all the words.

Chairman RANGEL. I am asking do you have a proposal.

Mr. SAMUELS. We do not have a specific proposal. It occurred to us that this provision is so complicated that it would be worth looking to see whether there were ways that would make it simpler and easier to use.

Chairman RANGEL. But not before the conference?

Mr. SAMUELS. No.

Chairman RANGEL. OK. Now, you say here that you oppose rifle shots. As you know, because they favor something-in any event, in a 1986 tax bill we had transition rules when a case came before the committee, and we thought that equity determined that we should provide the transition rules. Many companies then tried to meet that deadline, and they made the case to the committee and subcommittee and found that they needed an extension of the transition rule, but you have indicated that you oppose it without reviewing the merits because it favors a taxpayer. Without reviewing the merits of it or more importantly, without even reviewing the harm they could cause if relief is not granted.

How do you reach this broad-based decision that they are opposed merely because they are described as a rifle shot?

Mr. SAMUELS. I think that our position on the 1986 act transition rules is that those were all carefully negotiated at the time, discussed at the time, and it would be at this particular moment inappropriate to reopen those transition rules, that there could be perceptions of unfairness to some people who had to live with their transition rules and didn't come and ask for an extension of them, and it is one of those situations where we don't think that it is appropriate from a tax policy point of view to effectively reopen these very complicated provisions 7 years after the passage of the 1986 act.

Chairman RANGEL. You say this is not the appropriate time. You mean that you have shut down on this issue and there will be no appropriate time?

Mr. SAMUELS. Correct. We think that now 7 years have passed and that people have raised their issues. They had carefully considered those transition rules at the time, and there were a lot of those transition rules. It is inappropriate to open up the 1986 act 7 years later.

Chairman RANGEL. OK. Of course, if it is in a tax bill you may have to reconsider your position?

Mr. SAMUELS. Of course.

Chairman RANGEL. Of course. Now, as relates to the simplification and technical correction provisions in last year's bill, H.R. 11, I assume when I asked the questions before as related to technical corrections, that also would include no objections to the simplifications as well?

Mr. SAMUELS. That is generally correct. The only reason I hedge it slightly is that I think we would like to carefully look at each of the simplification proposals to satisfy ourselves that they are really simplification proposals. We strongly support the simplification effort. We are concerned about complexity in the tax law, and

so we look forward to working with you and your committee on simplification efforts.

Chairman RANGEL. I assume that Treasury still supports the empowerment and enterprise community zones that were dropped out of the Senate Finance Committee?

Mr. SAMUELS. Yes, sir, we support that proposal.

Chairman RANGEL. And the earned income tax credit, you still support it?

Mr. SAMUELS. Yes.

Chairman RANGEL. And I assume you object to the devastating cut in Medicare that was perpetrated by people on the other side?

Mr. SAMUELS. I can speak to the tax issues of the empowerment zones and the EITC. I am not authorized to discuss the Medicare cuts. That isn't an issue that I am responsible for.

Chairman RANGEL. Well, I assume that in your response to Mr. Hoagland, I think, that—or Mr. Kopetski, rather, that you are willing to work with the committee to make certain that you give us some guidelines as to where you would like to see the conference go? There is a further assumption that the bill that we will get will be substantially what was reported out of the Senate Finance Committee, but having made that assumption, it would be very helpful knowing what the administration's present position is as opposed to where they were when we supported the position in the House.

Mr. SAMUELS. I think once the Senate passes the bill we will start to prepare the administration's position on the differences between the House and Senate version and look forward to working with you on that.

Chairman RANGEL. That is very important. Are there other questions? Let me thank you, and I am going at this time to ask Mr. Payne to preside as I introduce a constituent to the Banking Committee. I will return. Thank you so much.

Mr. PAYNE [presiding]. Our next witness is Diana Josephson with the National Oceanic and Atmospheric Administration, U.S. Department of Commerce. Ms. Josephson is the Deputy Secretary for Oceans and Atmosphere, and your entire statement will be made a part of the record, and you may proceed as you wish.

STATEMENT OF DIANA H. JOSEPHSON, DEPUTY UNDER SECRETARY FOR OCEANS AND ATMOSPHERE, NATIONAL OCEANIC AND ATMOSPHERIC ADMINISTRATION, U.S. DEPARTMENT OF COMMERCE

Ms. JOSEPHSON. Mr. Chairman and members of the subcommittee, I am here today to testify in support of H.R. 2094, the Marine Navigation Safety Improvement Act of 1993. This bill would provide for transfer to NOAA of funds from the Harbor Maintenance Trust Fund. The funds, if made available, would enable NOAA to undertake a long overdue modernization and acceleration of our programs and services that support commercial navigation in U.S. waters. The results from these additional funds would be improved safety, efficiency, and profitability for maritime operations as well as a dramatic reduction in the risk of pollution to the coastal and marine environment.

As background, the Water Resources Development Act of 1986 established a harbor maintenance tax, an ad valorem tax on car-

goes moving through U.S. ports at the rate of 0.04 percent. The revenues are deposited in the Harbor Maintenance Trust Fund to be used primarily for reimbursing the Army Corps of Engineers for 40 percent of the Federal cost of its harbor dredging and maintenance operations.

As part of the Omnibus Budget Reconciliation Act of 1990, the fee was increased to 0.125 percent to recover 100 percent of the Corps' eligible costs and also to allocate part of the increase to NOAA to fund its programs and activities that support commercial navigation. However, the authorizing language to enable NOAA to gain access to the funds intended for its use was not enacted at that time. As a result, the funds intended for NOAA's use have been accumulating since January 1991 and now total about $113 million. Those funds continue to accumulate at a rate of about $45.5 million per year.

H.R. 2094 would authorize NOAA to gain access to these funds for the purposes specified in the 1990 proposal. These purposes are to support NOAA's programs in nautical charting, marine tides and circulation measurement and prediction, and marine weather services applicable to commercial navigation safety in U.S. waters. These additional funds would be requested as part of the President's budget.

As background, Mr. Chairman, NOAA has not been able to modernize its products and services to meet changing user needs. For example, more than half of the Nation's nautical charts are based on survey data collected over 50 years ago, including 25 percent of harbors and harbor approaches. Tidal current predictions for several major ports, including New York City and San Francisco, have been withdrawn because they have become sufficiently inaccurate to be potentially dangerous. A modernized national water level measurement network, consisting of 190 new gauges remains only half installed.

NOAA has been unable to expand its network of weather-reporting buoys that support commercial navigation on U.S. coastal routes in and near ports and harbors. NOAA has not been able to expand on its demonstrated capability to provide integrated real time water level, current, and weather information, like the system installed in Tampa Bay. The maritime industry will realize significant productivity gains through new navigation and positioning technologies such as electronic chart systems. However, NOAA cannot presently provide the digital chart data required to support this rapidly emerging technology that can reduce vessel workload.

Many of NOAA's weather-reporting buoys are supported by other agencies or supported only by contingency funds for alternate data sources until the new geostationary satellite systems are operational. The already limited network of 60 weather buoys could be cut in half, resulting in reduced marine weather-warning effectiveness. The importance of supporting the Nation's maritime industry cannot be overstated.

Over 99 percent of U.S. international trade outside of North America measured by tonnage is moved by marine transportation. U.S. international maritime trade is valued at approximately $500 billion. Over half of this commerce consists of petroleum and haz-

ardous materials. My detailed testimony sets forth potential benefits to be derived from use of state-of-the-art technology.

Mr. Chairman, during the administration's review of H.R. 2094 a few technical questions were identified regarding interpretation of the bill's language. We are in the process of preparing written comments outlining our concerns on these questions and would appreciate the opportunity to work with the committee's staff to resolve them. Pending the resolution of those issues, we strongly support H.R. 2094 and encourage its prompt enactment.

I would like to take this opportunity to express NOAA's appreciation to the sponsors of H.R. 2094 whose support may enable NOAA to make improvements to its navigation-related products and services that will truly be beneficial to the American public, our economy and our environment. Thank you, Mr. Chairman.

[The prepared statement follows:]

STATEMENT OF
DIANA H. JOSEPHSON
DEPUTY UNDER SECRETARY FOR OCEANS AND ATMOSPHERE
NATIONAL OCEANIC AND ATMOSPHERIC ADMINISTRATION
U.S. DEPARTMENT OF COMMERCE

BEFORE THE

SUBCOMMITTEE ON SELECT REVENUE MEASURES
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

JUNE 22, 1993

Mr. Chairman and Members of the Subcommittee:

My name is Diana Josephson, and I am the Deputy Under Secretary for Oceans and Atmosphere for the National Oceanic and Atmospheric Administration (NOAA). I am here today to testify in support of H.R. 2094, the "Marine Navigation Safety Improvement Act of 1993." This bill would provide for transfer to NOAA of funds from the Harbor Maintenance Trust Fund (HMTF) with the intent of enabling NOAA to undertake a long-overdue modernization and acceleration of its programs and services that support commercial navigation in U.S. waters. The results, should additional funds be made available, would be improved safety, efficiency and profitability for maritime operations, as well as a dramatic reduction in the risk of pollution to our coastal and marine environment.

Background:
The Water Resources Development Act of 1986 established a Harbor Maintenance Tax in the nature of an ad valorem tax on cargoes moving through U.S. ports, at the rate of 0.04 percent, with revenues deposited in the HMTF to be used primarily to reimburse the Army Corps of Engineers (COE) for 40 percent of the federal cost of its harbor dredging and maintenance operations. In 1990, the Bush Administration proposed to increase the tax rate to 0.125 percent, to recover 100 percent of the COE's eligible costs, and also to allocate part of the increase (0.01 percent of the value of the cargoes, equal to eight percent of the tax) to NOAA to fund its programs and activities that support commercial navigation.

The 1990 proposal was introduced on April 19, 1990, as S. 2469 and S. 2470. The fee increase was included in S. 2470, and enacted as part of the Omnibus Budget Reconciliation Act of 1990. However, the authorizing language in S. 2469 to enable NOAA to gain access to the funds intended for its use was not enacted at that time. As a result, funds intended for NOAA's use have been accumulating in the HMTF since January 1991, and now total approximately $113 million. Those funds continue to accumulate at a rate of about $45.5 million per year. The President's FY 1994 Budget anticipates legislation to "provide $45.5 million (in FY 1994) to fund ... (NOAA) programs that benefit the commercial navigation industry."

Anticipated NOAA Uses of HMTF Monies:
H.R. 2094 would authorize NOAA to gain access to those funds for the purposes specified in the 1990 proposal. Those purposes, consistent with international treaties, are to support NOAA's programs in nautical charting, marine tides and circulation measurement and prediction, charting survey ship support, and marine weather services applicable to commercial navigation safety in U.S. waters.

NOAA has not been able to modernize data acquisition, processing, and dissemination methods to meet changing user needs. For example, more than half the Nation's nautical charts are based on survey data collected over 50 years ago, including 25 percent of

harbors and harbor approaches. Fleet support to conduct new surveys has declined by 60 percent over the past 15 years. Tidal current predictions for several major ports, including New York City and San Francisco, have been withdrawn because they have become sufficiently inaccurate to be potentially dangerous. A modernized national water level measurement network consisting of 190 new gauges is only half installed.

NOAA has been unable to expand its network of weather-reporting buoys that support commercial navigation on U.S. coastal routes and in and near ports and harbors. In spite of recent success in applying modern technology to improve traditional services, NOAA has not been able to expand on its demonstrated capability to provide real-time water level, current, and weather information such as through the Tampa Bay "PORTS" (physical oceanographic real-time system) to improve navigation safety, enhance maritime commerce, and reduce environmental risks.

In addition, NOAA has not been able to modernize rapidly enough to keep pace with changing user needs for more accurate, higher quality, and more timely nautical charts, tide and current predictions, and marine weather forecasts. Maritime industries will realize significant gains in productivity through new navigation and positioning technology such as electronic chart systems. However, NOAA cannot presently provide the digital chart data required to support this rapidly emerging technology that can reduce vessel workload. In addition, real-time water level and current information, not presently provided by NOAA, is needed for safe navigation and for increased exports by using limited channel depths to maximal advantage.

Many of NOAA's weather reporting buoys are supported by other agencies such as the Minerals Management Service and the Corps of Engineers, or are supported by contingency funds for alternate data sources until the new geostationary satellite systems are operational. Once these temporary funding sources are depleted, the already limited network of 60 weather buoys will be cut in half resulting in reduced marine weather warning effectiveness.

Additional funds made available from the HMTF will enable NOAA to be more responsive to future needs, and will reduce the risk of maritime accidents that will, most assuredly, result in loss of life and property and significant damage to the environment. Over 99 percent of U.S. trade outside of North America, measured by tonnage, is moved by marine transportation. U.S. international maritime trade is valued at approximately $500 billion. Over half of this commerce consists of petroleum and hazardous materials. Over three million cargo vessel transits are made in U.S. ports and coastal waters each year. U.S. ports are projected to invest $5.4 billion over the next five years to upgrade their facilities. However, NOAA at present is unable to make comparable improvements in marine navigation products and services that will be necessary to support expanded U.S. port facilities. Too many avoidable accidents have already happened -- it is time to invest in prevention.

If NOAA obtains additional funds via the HMTF, state-of-the-art technology can be acquired to modernize data acquisition, processing and distribution capabilities. Among the potential benefits are:

- NOAA would be able to conduct full-bottom sea floor charting and increase survey efforts to provide modern coverage of the Nation's most critical ports and harbor approaches within the next five years.

- NOAA could increase vessel time devoted to chart-related surveying by increasing efficiency with upgraded technology, extending the operating periods for existing survey ships, and contracting for survey support with

qualified firms in the private sector.

- Chart production could be converted to an automated system within five years. The system would maintain traditional products, provide a new suite of digital electronic charts to support advanced, integrated navigation systems, and provide data for the base layers of a marine geographic information system.

- NOAA could complete modernization of its National Water Level Observation Network and provide real-time tide and water level information for navigation safety and other maritime activities.

- NOAA could implement advanced capabilities to provide real-time tide, current and marine weather data systems in major ports.

- NOAA could develop digital tidal and tidal current prediction products, techniques for forecasting water levels and currents based on real-time and data and high-resolution, short-range atmospheric forecasts, and improved marine weather products and distribution services.

- NOAA could increase the storm detection capabilities of the new coastal Doppler radar and satellite remote imaging systems if ground truth to validate new sensing techniques is provided by an expanded weather buoy network in coastal waters and port and harbor areas.

Additional funds through enactment of this legislation also would allow for modernization of NOAA's nautical charting and marine navigation related activities which in turn would provide the public with substantial environmental and economic benefits. Modernized products and services would:

- Assist in preventing life and property losses, as well as environmental damage, from groundings and other accidents;

- Increase productivity, efficiency, and competitiveness of maritime commerce through timely digital information products for navigation, modern nautical charts, real-time information and predictions of tides and currents, and improved short term marine warnings and forecasts;

- Improve oil and hazardous materials spill response efforts in U.S. ports, harbors and coastal waters; and

- Improve planning for and management of coastal ocean resources through the use of automated databases of hydrographic and physical oceanographic data.

Responses to Concerns about the Legislation:
NOAA is aware of two concerns related to H.R. 2094. As we understand them, the concerns are: (1) if NOAA gains access to funds in the HMTF, funds available to the COE for dredging operations would be reduced; and (2) allowing NOAA to use the accumulated balance in the HMTF would weaken the position of some ports in northern-tier states that support a roll-back of the cargo fee based on the assertion that the harbor maintenance tax places them at a competitive disadvantage relative to Canadian ports.

First, let me state that enactment of H.R. 2094 would not reduce funding available to the COE for its dredging and maintenance activities. As a result of the fee increase that was enacted in 1990, the COE now recovers 100 percent of the federal share of all of its eligible projects. In contrast, a roll-back of the cargo fee, however, could reduce funding available to the COE for port and channel dredging. Indeed, the President's Budget for

FY 1994, in the COE section, anticipates legislation to "provide $45.5 million (in FY 1994) to fund ... (NOAA) programs that benefit the commercial navigation industry."

In the absence of dredging, or in locations where toxic sediments may preclude annual dredging, NOAA could, with access to HMTF monies, provide real-time water level information that is critical to allow deep-draft vessels to operate in limited-depth channels.

Second, with respect to the claim that the harbor maintenance tax places some ports in northern-tier states at a competitive disadvantage, NOAA is not aware of any specific evidence that the harbor maintenance tax, even after the 1990 increase, has resulted in a significant diversion of cargo from U.S. northern-tier ports to our Canadian neighbors. NOAA believes that enhanced safety and efficiency of navigation supported by improved data, products, and services and the increased cargo capacities that can be supported by real-time water level and current information will far more than offset the costs of any cargo diversions that might occur.

Conclusion:
Mr. Chairman, during the Administration's review of H.R. 2094 a few technical questions were identified regarding interpretation of the bill's language. We are preparing written comments which will outline our concerns on these technical questions and would appreciate the opportunity to work with the Committee's staff to resolve them. Pending the resolution of these technical issues, we would strongly support H.R. 2094 and encourage its prompt enactment. I also would like to take this opportunity to express NOAA's appreciation to the sponsors of H.R. 2094, whose support may enable NOAA to make improvements to its navigation-related products and services that will truly be beneficial to the American public, our economy and our environment.

This concludes my statement, and I will be pleased to respond to any questions. Thank you for the opportunity to appear before you today.

Mr. PAYNE. Thank you very much, Ms. Josephson. As I understand it, what you intend is to be able to get an additional $45.5 million this year from those funds that are already in the trust fund, is that correct?

Ms. JOSEPHSON. The President's request is for $45.5 million of funds from this trust fund for fiscal year 1994, yes.

Mr. PAYNE. And that is the entire amount of money that you are interested in?

Ms. JOSEPHSON. That is the President's request, yes.

Mr. PAYNE. So despite the fact that there are more moneys than that in the trust fund, you are not looking at gaining access to those funds at this time but rather the $45.5 million?

Ms. JOSEPHSON. That is correct. I believe that this question is one of the questions which we want to discuss with the committee staff and resolve.

Mr. PAYNE. Now, I understand that the amounts that are transferred from the Harbor Maintenance Trust Fund to support the activities of NOAA will be subject to appropriations, and therefore will remain subject to the discretionary spending caps. Therefore do you think that NOAA necessarily will get a larger appropriation if funds are set aside within the harbor maintenance trust fund?

Ms. JOSEPHSON. The answer to that isn't clear to me at this point. I think it is going to depend on the discussions that we will be having with committee staff and with your members. These are some of the issues which remain unresolved, and I can't comment on them at the moment.

Mr. PAYNE. Thank you very much. Mr. Hoagland.

Mr. HOAGLAND. No questions.

Mr. PAYNE. Thank you very much. Thank you for your testimony. We do appreciate it.

[The National Oceanic and Atmospheric Administration has declined to respond to the following questions submitted by Mr. McDermott.]

QUESTIONS FOR THE RECORD SUBMITTED BY REPRESENTATIVE JIM MCDERMOTT TO DIANA JOSEPHSON, DEPUTY SECRETARY FOR OCEANS AND ATMOSPHERE, NATIONAL OCEANIC AND ATMOSPHERIC ADMINISTRATION

1. The harbor maintenance tax and the Harbor Maintenance Trust were established for the sole purpose of funding harbor maintenance. If we allow funds to be diverted for nautical charts, doesn't this invite other extraneous uses of the Trust Fund therefore destroying the very idea of a "trust fund?"

2. Are you aware of the extent to which the harbor maintenance tax already harms the competitiveness of U.S. exports and U.S. ports that compete with Canada? Wouldn't all these proposed extraneous uses of the Trust Fund keep driving the harbor maintenance rate higher and higher?

3. Wasn't this originally proposed by the Bush administration? Congress rejected the Bush proposal because they saw it as backdoor spending. What's different about your proposal?

Mr. PAYNE. Our first panel is made up of Cora Cahan, the president of New 42nd Street, Inc. in New York; Dale Wickham, and Matthew Mayer, executive vice president and general counsel of the Park Tower Realty Corp., representing Times Square Center Associates in New York; Lawrence Sumney, chairman, chief executive officer of the Semiconductor Research Corp., Research Triangle Park in North Carolina, speaking for the Alliance of Collaborative

Research; and Robert S. Gregg, vice president of finance and chief financial officer of Sequent Computer Systems.

As the Chairman mentioned as we started this hearing, I would like for you to confine your oral remarks to 5 minutes and any statements that you have will be entered into the record. Ms. Cahan, if you would proceed, please. Thank you.

STATEMENT OF CORA CAHAN, PRESIDENT, THE NEW 42ND STREET, INC., NEW YORK, N.Y.

Ms. CAHAN. Mr. Chairman and members of the committee or the subcommittee, my name is Cora Cahan, and I am the president of the New 42nd Street, Inc. The New 42nd Street is an independent, not-for-profit organization chosen by the city and State of New York to resurrect six historic theaters on 42nd Street as part of the overall redevelopment of this legendary corridor. It currently holds a 99-year lease on the Victory, Lyric, Times Square, Apollo, Selwyn, and Liberty theaters.

Built in the early part of this century, these theaters inaugurated a flurry of day and nighttime activity in the Times Square area with plays, musicals, comedies, and vaudeville, and quickly established New York City's preeminence as a world capital for popular entertainment. For decades, they remained the centerpiece of this thriving district, dictating the latest trends and drawing thousands of visitors from every corner of this country and abroad. Beginning with the depression, however, their fortunes reversed. The slow but steady decline that followed has afflicted the block with unsavory images of urban decay and blight.

With a major new initiative by the public sector, the 42nd Street Development Project, the street is once again poised for renewal. As we near the 21st century, our organization is preparing to reclaim these theaters for the residents of New York and the visitors who continue to flock to 42d Street looking for traces of its fabled past. However, in such a time of diminishing resources, our task is daunting.

Change of the scale that is needed on 42d Street requires the marshaling of public and private investment. A major hallmark of this project is the magnitude of private investment required, and already committed. Our own plans rely heavily on attracting private, commercial investors and organizations to lease, renovate, and operate the theaters. But we have found that 42d Street's prime location and historic legacy are by themselves insufficient inducements.

To begin with, 42d Street's current image poses a tangible risk for new commercial entertainment. The public has to be convinced to come back to 42d Street after decades of staying away. Second, the theaters, nearly 100 years old, require substantial capital investment to equip them for another century of operation. Because the potential for future profits remains highly speculative, encouraging such investment in the theaters requires more immediate incentives.

We are hopeful that the city and State's new "interim" plan for retail development will begin to foster visible change on the block. However, Federal assistance, through tax credits and other forms of tax relief, continues to form a crucial part of the total strategy

to attract commercial investors and operators to the 42d Street theaters.

In our discussions with prospective tenant/investors, the grandfathering of the 42d Street project by provisions in the 1986 Tax Reform Act has aroused considerable interest. It should be stated that we began our undertaking in 1990 in the midst of the nationwide recession. While we hope to find tenants for some of the theaters over the next 3 to 5 years, we are not sanguine that all of the theaters within our jurisdiction can be reclaimed and placed in service by January 1, 1998.

I am here today to request the subcommittee's support in waiving this deadline. The theaters of 42d Street are not merely aging dinosaurs on a dilapidated center city block. They are national treasures, bearing witness to the social history of American entertainment. Moreover, they are the essential raw materials for any plan to redevelop this area for the benefit of the local citizenry as well as the throngs of American and international visitors who still assemble at this, the "crossroads of the world." Thank you.

Mr. PAYNE. Thank you, Ms. Cahan.

Mr. Mayer.

STATEMENT OF MATTHEW MAYER, EXECUTIVE VICE PRESIDENT AND GENERAL COUNSEL, PARK TOWER REALITY CORP., ACCOMPANIED BY DALE W. WICKHAM, WASHINGTON COUNSEL, ON BEHALF OF TIMES SQUARE CENTER ASSOCIATES

Mr. MAYER. Good morning, Mr. Chairman, members of the committee, my name is Matthew Mayer. I am executive president and general counsel of Park Tower Realty Corp. based in New York City. I am accompanied by our counsel, Dale Wickham of Wickham & Associates from Washington, D.C. A Park Tower affiliate is a general partner in Times Square Center Associates, the lead developer of the 42d Street project. The other general partner is the Prudential Insurance Co. of America.

The project is a comprehensive plan for rehabilitating the large and blighted Times Square 42d Street area in New York City. I am appearing today on behalf of Times Square Center Associates to support a technical amendment proposed by Chairman Rangel which would preserve and continue tax incentives enacted in the Tax Reform Act of 1986 for this urban renovation project. These tax incentives presently apply to the project only if the property is placed in service before January 1, 1998.

The proposed amendment would remove the January 1, 1998, deadline if at least $250 million were incurred or committed for development of the project before April 15, 1993. These tax incentives consist of favorable depreciation allowances, a modified form of investment tax credits for properties such as elevators and escalators, and the continuation of pre-1986 tax rules for amortizing the cost of leasehold improvements and construction period interest.

Enactment of the proposed amendment this year will have no effect on Federal tax revenue receipts during the 5-year fiscal period used for Federal budget estimating purposes. This conclusion is based on an opinion from Randall Weiss of Deloitte & Touche, a

copy of which is attached to my written statement. A question has been raised by staff whether the amendment could conceivably affect income tax liabilities prior to 1999 by reason of the technical operation of certain rules relating to construction period interest and the credit applicable to qualified expenditures. We believe that these conceivable revenue effects do not present a problem as a factual matter. Nevertheless, our representatives have prepared a technical amendment to the proposal which is set out in my written statement and which would ensure the proper result as a matter of law.

New York City and the New York State Urban Development Corp. have been working with private developers for more than a decade to make Times Square/42d Street project a showcase of private and public partnership in urban renovations. The city and UDC have provided public sponsorship and substantial support in the form of city tax abatements and the exercise of State condemnation powers. The city's interest and support are evidenced by letters from Mayor Dinkins to Congressman Rangel and Senator Moynihan expressing support for the proposed legislation. These letters are described in detail in my written statement.

The proposed waiver of the January 1, 1998 placed in service date is essential to preserve the tax incentives for the project. Absent such a waiver most of the tax incentives enacted for the project will simply go down the drain because it is now projected that only a small part of the project's property will be placed in service before that date. Construction of the project has been delayed by events beyond the control of the city, UDC and the developers, most importantly 46 lawsuits brought in the 1980s to halt the project.

Despite the passage of time, more than $250 million has already been invested in the project by Times Square Center Associates in reliance upon the availability of these tax incentives. Action this year is needed on this amendment to provide an economic basis for the developers to remain in the project. Doing so will require them to enlarge the financial commitments long before any return on their investment can be realized.

The continued availability of the tax incentives is also essential to encourage tenants to make long-term commitments to lease space in the building, a prerequisite of obtaining construction financing. Mr. Chairman, I have submitted a longer written statement for the record, and I will be happy to try to answer any questions which you or any members of the committee may have. Thank you, sir.

Mr. PAYNE. Thank you very much, Mr. Mayer.

[The prepared statement follows:]

STATEMENT ON BEHALF OF TIMES SQUARE CENTER ASSOCIATES BY MATTHEW MAYER, EXECUTIVE VICE PRESIDENT AND GENERAL COUNSEL OF PARK TOWER REALTY CORPORATION, IN SUPPORT OF AMENDMENT TO WAIVE THE JANUARY 1, 1998 PLACED IN SERVICE DATE FOR NEW YORK CITY'S TIMES SQUARE - 42ND STREET URBAN RENOVATION PROJECT DESCRIBED IN SECTION 204(a)(1)(E) OF THE TAX REFORM ACT OF 1986

I am Matthew Mayer, Executive Vice President and General Counsel of Park Tower Realty Corporation ("Park Tower"), based in New York City. I am accompanied by our counsel, Dale W. Wickham of Wickham & Associates in Washington, D.C.

A Park Tower affiliate is a partner in a partnership named Times Square Center Associates ("TSCA") which is the lead developer of the Times Square - 42nd Street Urban Renovation Project ("Project"). Another principal partner in TSCA is the Prudential Life Insurance Company of America.

I am appearing here today, on behalf of TSCA, to support an amendment, proposed by Mr. Rangel, which would preserve and continue tax incentives enacted in the Tax Reform Act of 1986 for this urban renovation project. These tax incentives presently apply only to Project property placed in service before January 1, 1998. The proposed amendment would remove the January 1, 1998 deadline, if at least $250 million was incurred or committed for development of the project before April 15, 1993. These tax incentives consist of favorable depreciation allowances, a modified form of investment tax credit for properties, such as elevtors and escalators, which qualify for the credit, and the continuation of pre-1986 tax rules for amortizing the cost of leasehold improvements and construction period interest.

Present Law

The 1986 Act reduced cost recovery allowances for property placed in service after 1986. In addition, the 1986 Act revised the rules relating to the amortization of construction period interest and the cost of leasehold improvements. The 1986 Act provided certain exceptions to these changes.

Section 204(a)(1)(E) of the 1986 Act applied one exception for a project meeting the following criteria:

> (1) a State or an agency, instrumentality, or political subdivision thereof approved the filing of general project plan on June 18, 1981, and on October 4, 1984, a State or an agency, instrumentality, or political subdivision thereof confirmed such plan; (2) the project plan as confirmed on October 4, 1984, included construction or renovation of office buildings, a hotel, a trade mart, theaters, and a subway complex; and (3) significant segments of such projects were the subject of one or more conditional designations granted by a State or an agency, intrumentality, or political subdivision thereof to one or more developers before January 1, 1985.

The exception applies with respect to property only to the extent that a building on such property site was identified as part of the project plan before September 26, 1985, and only to the extent that the size of the building

on such property site was not substantially increased by reason of a modification of the project plan with respect to such property on or after such date.

These rules were explained by Congressional sponsors of section 204(a)(1)(E) in 1986 as follows:

> "Thus, for example, if the project plan as of the relevant date provided for an open space area, and after such date the project plan is amended to permit construction of a building on such site, such building would not qualify for effective date relief. Furthermore, if on the relevant date the project plan provided for a 100,000 square foot building on a specific property site, and subsequent to the relevent date the project plan was amended to allow a 300,000 square foot building on such site, only one-third the cost of the building would be eligible for effective date relief. The amendment contemplates that, so long as some building is identified in the project plan for a specific site on the relevant date, effective date relief would be granted even though the project plan is subsequently modified to change the nature, design or use of such building; relief in such case, however, would not apply with respect to any increased square footage of such building that occurs by reason of the modification of the project plan."

The exception does not apply unless the property is placed in service before an applicable date. The applicable date for property in this Project is January 1, 1998.

This 1998 placed-in-service deadline applies to both property with a class life of 20 years or more and, by reason of section 203(b)(2)(B)(ii) of the 1986 Act, to property with a class life of at least 7 years but less than 20 years.

Description of Proposal

The proposal would waive the January 1, 1998 placed in service requirement for the project described in section 204(a)(1)(E) of the 1986 Act, so long as at least $250 million has been incurred or committed to this project as of April 15, 1993. The proposal would amend subparagraph (E) of section 204(a)(1) of the 1986 Act by adding at the end thereof the following new sentance:

> "For purposes of applying section 203(b)(2) to this subparagraph, property shall be treated as placed in service before January 1, 1998, if at least $250,000,000 was incurred or committed for development of the project before April 15, 1993."

Thus, the proposal would apply to all property which is a part of the project, including the office buildings, the theaters, the hotel, the trade mart, etc. The effective date of the proposal would be the date of enactment.

To ensure the proposal's objective of assuring that the tax incentives preserved for the Times Square Project by the 1986 Tax Act will continue to be available without regard to the January 1, 1998 placed-in-service deadline set in the '86 Act, implementation of it will require enactment not only of the proposed language set forth below to amend section 204(a)(1)(E) of the '86 Act but also of such other legislative language as is believed by Congressional draftsmen to be needed to prevent frustration of this objective. This would include changes to the effective date lanuage of the provisions of the pending 1993 revenue reconciliation bill that would extend the cost recovery

period for nonresidential real property. This change would clarify the intent that these provisions, which generally would apply to property placed in service on or after February 25, 1993, are not intended to apply to property described in section 204(a)(1)(E) of the 1986 Act. (These provisions are section 14151(b) of the House-passed bill and section 8151(b) of the Senate Committee on Finance's reported version of the bill.) Comparable changes may be required to later or previously enacted revenue measures.

Description of the Times Square - 42nd Street Renovation Project

The Times Square - 42nd Street Urban Renovation Project (the "Project") meets the criteria set forth in section 204(a)(1)(E) of the 1986 Act. The Project is a comprehensive project for rehabilitating the large, blighted Times Square - 42nd Street area of New York City. The City and the New York State Urban Development Corporation ("UDC") have been working with private developers for more than a decade to make this Project a showcase of private and public partnership in urban renovation. The City and UDC have provided public and private sponsorship and substantial support in the form of City tax abatements and the exercise of State condemnation powers. They also have elicited a commitment from the developer that women, minorities, and local residents will receive meaningful percentages of the construction contracts and employment generated by the Project. However, the Project is primarily reliant on private development and financing, and continuation of the existing federal tax incentives is essential to retain the participation of the private developers, who have already incurred or committed expenditures of more than $250 million with no return to date on their investment, and who will ultimately invest more than $2 billion.

In the near term, commencing in early 1994, the Project contemplates the renovation of historic theaters and interim retail low-rise redevelopment, and in the longer term, it contemplates the construction of office buildings, a hotel, and a trade mart. The State and City agencies approving the plan have made specific findings that the Project would alleviate the area's high crime rate, blight, and physical decay. In fact, the condemnation in the Project area and the elimination of "blighting" uses -- funded by more than $200 million provided by private developers of the Project -- have already made significant reductions in the crime rate and urban blight.

The Specific Federal Tax Incentives Involved

The specific federal tax incentives preserved for the Project by the 1986 Act and by the proposed legislation are: (1) the 19-year 175% declining balance method depreciation for real property (in lieu of 31 1/2 year straight-line depreciation presently allowed for nonresidential property); (b) pre-1986 ACRS depreciation rather than MACRS depreciation for personal property; (3) a 6.5% investment credit with basis reduction in the amount of the credit for eligible property; (4) amortization of leasehold improvements over the lease term when shorter than the useful life of the improvements; and (5) pre-1986 amortization of construction period interest rather than capitalization of such interest into the basis of the constructed property.

Delays in Project Construction

Construction of the Project has been delayed by events beyond the control of the City, UDC, and the developers. These delays resulted from a radically changed market for office buildings and more than 4 years of lawsuits

challenging the condemnations and other aspects of the Project, all which were resolved in the favor of the Project. In addition, the City, the State, and the developers are now in the process of amending the project plan to defer construction of the office towers while proceeding with an interim retail low-rise redevelopment. As a consequence, a significant portion of the properties -- particularly the office towers which will require a total investment of more than $2 billion -- will not be placed in service before January 1, 1998, and thus, absent the proposed waiver of the deadline, would be denied the incentives which Congress enacted to facilitate completion of the Project. The cost of these incentives has already been taken into account in federal budgetary estimates.

New York City Advocates Relief Legislation

On April 23, 1992, David N. Dinkins, the Mayor of New York City, sent two identical letters advocating legislation needed to ensure completion of the Times Square-42nd Street Development Project. The letters were addressed to the Honorable Charles B. Rangel and Senator Daniel P. Moynihan. Each letter enclosed a text of the proposed amendment similar to that proposed by Mr. Rangel for consideration by this Subcommittee. The body of each letter is quoted below:

> "I request your able assistance in sponsoring and in working to secure enactment of legislation needed to ensure the completion of the Times Square - 42nd Street Development Project. The text of the proposed amendment and an explanation are enclosed.
>
> "The project is publicly sponsored by New York City and the New York State Urban Development Corporation, but it is almost entirely reliant on private development and financing. It is a comprehensive plan to rehabilitate one of our nation's renowned landmarks, the Times Square-42nd Street area. Unfortunately, this project has suffered unforeseen delays because of litigation brought against it by local property owners, among others.
>
> "The project's potential benefits for New York City are immense. They include elimination of blight and physical delay in the area. The project will also reduce crime in the 42nd Street subway station and the Times Square neighborhood, an area which has one of the highest crime rates in the City. The project will provide thousands of jobs during the construction period. It will permanently increase employment in the area by more than six-fold. It will restore a number of the area's historic theaters and will revitalize the 42nd Street area as a cultural and entertainment center and tourist attraction. The City's infrastructure will also be improved by substantial renovation of the Times Square subway complex.
>
> "The project has moved forward, and the developer has committed over $200 million, predicated on the tax treatment set out in the 1986 Tax Reform Act. Now, because of delays, the City risks losing the significant public benefits associated with the project.
>
> "This year would be especially opportune for the enclosed amendment because, I am assured, there would be no revenue loss within the five-year period used for revenue estimating.

"Thank you for your assistance with this matter."

Benefits to New York City

The Project benefits to New York City are enormous. The Project would --

1. Eliminate blight and physical decay in the area;

2. Reduce crime in the 42nd Street subway station and the Times Square neighborhood, an area which has one of the highest crime rates in the City;

3. Provide tens of thousands of jobs during the construction period for otherwise underemployed persons and for minorities, women, and local individuals, with very specific goals for obtaining a substantial portion of the services and supplies from enterprises of such persons;

4. Permanently increase employment in the area by more than six-fold (from 4,000 people to an estimated 25,000);

5. Restore a number of the area's historic theaters;

6. Revitalize the 42nd Street area as a national cultural and entertainment center and tourist attraction; and

7. Increase City taxes and revenues from the Project area by more than six-fold.

Revenue Effect

Enactment of the amendment in 1993 would involve no revenue loss within the five-year period used for federal budget estimates, according to a revenue estimate prepared by Randall D. Weiss of Deliotte & Touche, a copy of which is attached to this statement.

A technical question has been raised whether the amendment could conceivably affect income tax liabilities prior to 1999 by reason of the technical operation of certain rules relating to construction period interest and the credit applicable to qualified progress expenditures. We believe that these conceivable revenue effects do not present a problem as a factual matter. Nevertheless, our representatives have prepared a technical amendment to the proposal which would preclude such revenue effects as a matter of law. As so amended, the proposed legislation would amend subparagraph (E) of section 204(a)(1) of the Tax Reform Act of 1986 by adding at the end thereof the following new sentences:

"For purposes of applying section 203(b)(2) to this subparagraph, property shall be treated as placed in service before January 1, 1998, if at least $250,000,000 was incurred or committed for development of the project before April 15, 1993. The preceding sentence shall not apply to any property placed in service during the period beginning on January 1, 1998, and ending on September 30, 1998, and shall not allow the deduction for construction period interest, or the credit applicable to qualified progress expenditures, for any taxable year that includes any part of such period or that precedes such period."

Deloitte & Touche

Suite 350N
1001 Pennsylvania Avenue N.W.
Washington D.C. 20004-2594
Telephone (202) 879-5600
Facsimile (202) 879-5309

May 21, 1993

Revenue Effect of Extension of Placed-In-Service
Date For Tax Provision
Affecting The Times Square-
42nd Street Urban
Renovation Project

Summary

Present law enacted in the Tax Reform Act of 1986 continues certain pre-1986 tax benefits for properties which are an integral part of the Times Square-42nd Street Urban Renovation Project if the properties are placed in service before January 1, 1998.

The legislative proposal described in the attached document would treat property which is an integral part of the Project as placed in service before January 1, 1998 if at least $250 million was incurred or committed for development of the Project before April 15, 1993.

Based on information and analysis provided by the Project's coordinating developer, counsel for the developer, and the New York State Urban Development Corporation, the proposed legislation can be expected to have no effect on the federal income tax liability of any taxpayer for taxable years beginning before July 1, 1998. Therefore, the proposal would have no effect on revenue received by the U.S. Treasury during the period through fiscal year 1998.

If the proposal is not adopted, the developer may abandon the project, thus generating an abandonment loss deduction, within the next few years. If the revenue baseline were to assume that this abandonment would occur, and if enactment of the proposal would prevent the abandonment from occurring, then enactment of the proposal would increase receipts by approximately $95 million.

Explanatory Memorandum

The conclusion that the legislative proposal described in the attached document would have no effect on revenue received by the U.S. Treasury during the period through fiscal year 1998 is based upon information and analysis provided by the Project's coordinating developer, counsel for the developer, and the New York State Urban Development Corporation and upon the considerations set forth below.

The provision in section 204(a)(1)(E) of the Tax Reform Act of 1986 applicable to the Project provides for the continuation of the pre-1986 rules for investment credit (in modified and reduced form), depreciation, amortization of leasehold improvements, and construction period interest. The proposed legislation would have no revenue effect as to the application of these tax benefits to property placed in service before January 1, 1998 because such benefits are provided under present law.

With respect to Project property actually placed in service on or after January 1, 1998, the proposal would not affect income tax liabilities of calendar year taxpayers prior to 1999 to the extent that such liability depends on the rules for investment credit, depreciation, or amortization of leasehold improvements because these rules do not affect tax liability until after the property is placed in service, i.e., after 1997 for calendar year taxpayers. Since it is expected that no property which is an integral part of the Project will be placed in service during 1998, the proposal would not affect income tax liabilities for 1998 by reason of the rules for investment credit, depreciation or amortization of leasehold improvements.

The tax benefit resulting from amortization of construction period interest could potentially affect income tax liabilities prior to 1999 with respect to property placed in service during or after 1999. However, based on present projections of the coordinating developer and the New York Urban Development Corporation, no construction period interest will be incurred prior to 1999 with respect to property placed in service during or after 1999.

The developer of the office towers has a capitalized investment of over $280 million in the project and projects sufficient income to utilize an ordinary or capital abandonment loss deduction in this amount. Since the developer will soon be called upon to make substantial additional investment in the project but will have to wait for at least a decade for a return on its investment, there is a substantial likelihood that the developer may abandon the project within the next few years unless the tax incentives are extended. If the revenue baseline, which assumes that the tax incentives for the project will not be continued, were to incorporate the assumption that the project will be abandoned before the end of 1997, and if enactment of the proposal would prevent the abandonment from occurring, then enactment of the proposal would increase federal budget receipts during the five-year estimating period by approximately $95 million ($280 million x 34% corporate tax rate).

Randall D. Weiss
Director of Tax Economics

Mr. PAYNE. Our next witness is Mr. Lawrence Sumney with the Alliance for Collaborative Research. Mr. Sumney.

STATEMENT OF LARRY W. SUMNEY, CHAIRMAN, ALLIANCE FOR COLLABORATIVE RESEARCH, AND CHIEF EXECUTIVE OFFICER, SEMICONDUCTOR RESEARCH CORP., RESEARCH TRIANGLE PARK, N.C.

Mr. SUMNEY. Thank you. Mr. Chairman, members of the subcommittee, I appreciate the opportunity to testify at this critical juncture. Given the long witness list, I trust you won't object if my extended remarks are entered into the record. I am here today representing the Alliance for Collaborative Research and I have with me Dan Mastromarco, our deputy director and also a member of the Jefferson Group here in Washington.

We want to urge your support for modifications to the research and experimentation tax credit, modifications that we believe would reward collaboratively conducted research. These modifications, with bipartisan backing, are embedded in S. 666 introduced by Senators Baucus and Danforth and S. 379 by Senator Joseph Lieberman. They derive from legislation introduced by Congressman Sander Levin in the 102d Congress and were the subject of his testimony before this subcommittee last week.

The alliance represents many of the Nation's leading research consortia conducting almost $2 billion in industry-led cooperative R&D from digital imaging technology to artificial intelligence. Each year about this time Congress begins its perennial debate over one of the most important incentives for competitiveness, the R&E tax credit, specifically whether the credit should be made permanent. When that debate is completed and the predictable result reached, we turn our attention away for another 12 months.

Unfortunately, aspects of the budget process often preempt important discussions over ways in which the credit might be improved.

Nobody questions the importance of R&D for our continuing economic prosperity, and few question the need for the credit. The credit is soundly grounded in the premise that firms, in the absence of the credit, will underinvest in research and experimentation because they are unable to capture the greater rewards that come to society from their innovations.

Without adequate R&D, however, we will surely lose the race for innovation that forms the basis for new products, enhanced standard of living for our citizens, and ultimately world influence. But the credit has not inspired the level of R&D we as a Nation must promote, and it has not kept pace with the way R&D is conducted today. Although meant to stimulate new research, the rate of new R&D in the United States is in decline relative to our competitors. Although temporary allocation rules seek to ensure R&D is conducted within our borders, we have witnessed an increasing amount of research conducted overseas by U.S. companies. When our industries make the necessary outlays, this technology is too often assimilated into goods and manufacturing processes more swiftly by our competitors.

The reasons for the disturbing trend are exacerbated by our failure to adequately reward cooperative research, a problem S. 666

seeks to correct. Congressman Levin's recommendations, shared by others on this committee, would not only permanently extend the credit, but provide a 20 percent flat credit for research conducted jointly by five or more companies and fewer than five companies if they are competitors.

This change will have many beneficial effects. By stimulating industry-led collaborative efforts, the credit will maximize finite private and public sector funds, encouraging firms to leverage resources.

This reduces costs of otherwise duplicative R&D; for example, R&D to meet safety, environmental, or health standards. According to a recent survey of the Nation's consortia, 35 percent of consortia research is intended to reduce unwanted redundancy. This efficiency also extends to the public fiscal interest.

While a common test of the credit's effectiveness has been how many research dollars it stimulates, a more correct measure is how efficiently it promotes research, how quickly it promotes dissemination of its results and how effectively it assists in the commercialization. This modification will reduce redundant research on which the incremental credit is now taken, ensure innovations are considered for wide application, and enable U.S. companies to bring technology to market faster and to advance the starting line of competition.

Second, in addition to eliminating duplication, the modification will advance policies of the existing section 41 credit by stimulating truly new research, research that wouldn't be taken individually. Finally, it is important to note that this change by encouraging collaboration will indirectly reward companies that cannot take the incremental credit because they do not have taxable income and directly reward companies whose expenditures have fallen hopelessly below the R&D base for the incremental credit. It also benefits small firms who are disinclined to invest in processes or other technologies which in the long run are key to their survival.

Mr. Chairman, our international marketplace has imposed a new reality on our business. In this new reality, U.S. businesses no longer battle for domestic market share, but fight to survive in the global marketplace. Competing in technology today is a far cry from Adam Smith's pin factory. Competition is increasingly defined by alliances competing against other alliances, team against team. Of the $150 billion in R&D conducted in the United States, only about 1 percent is conducted by consortia.

Innovation can start with a change in U.S. tax policy. We elicit your help in ensuring that this change becomes part of the conference agreement. Thank you.

[The prepared statement follows:]

STATEMENT OF LARRY W. SUMNEY
OF THE ALLIANCE FOR COLLABORATIVE RESEARCH

Mr. Chairman and Members of the Subcommittee on Select Revenue Measures:

Thank you for the opportunity to testify on the research and experimentation (R&E) tax credit, and on the need to provide an enhanced reward for research conducted collaboratively.

I represent the Alliance for Collaborative Research (Alliance) as President and Chief Executive Officer of the Semiconductor Research Corporation (SRC), one of the leading consortia in the semiconductor field. As spokesman for the Alliance, I fully support a permanent R&E tax credit. I commend the Administration and the Ways and Means Committee for taking this important step.[1] However, like other witnesses before this subcommittee last week, I am not resolved that the R&D tax credit and other incentives for R&D have inspired the level of R&D which we as a Nation must promote or have kept pace with new paradigms in the way in which R&D is conducted today. The credit should not be designed to reward only incremental individual research for the sake of research, it should also be designed to reward companies which leverage their limited R&D dollars through collaboration.

It is time we advanced the discussion beyond the perennial call to extend the credit to enact the changes that will foster private-public partnerships.

The Alliance represents most of the Nation's leading research and development (R&D) consortia. Members of the Alliance, with facilities throughout the United States, conduct significant industry-led cooperative R&D, from digital imaging technology to flexible computer integrated manufacturing to artificial intelligence. More than 2,000 companies, large and small, participate in cooperative R&D through these consortia, and our members represent more than 50 percent of the manufacturing base by gross receipts. By coordinating joint R&D projects between firms, often competing firms, we leverage limited R&D resources from the Federal, state and private sector, ensure speedy and efficient technology deployment, and advance the starting line for competition between our manufacturers by reducing the costs of technology and the time to absorb that technology.

Mr. Chairman: During each of the past ten years, at about this time of year, the Congress begins its perennial debate over extension of what is meant to be one of the most important incentives for competitiveness in the Internal Revenue Code -- the R&E tax credit. Each year, the debate centers around whether "the credit" should be made permanent, or should be extended temporarily because of budgetary constraints.

Unfortunately, the exigencies of the budget process not only preempt discussion over ways in which the credit can be enhanced, but predetermine whether it ought to be made permanent. This year the Senate Finance Committee has once again temporarily extended the credit, setting the stage for the next perennial debate. As you know, the House passed permanent extension of "the" R&D tax credit in the tax package two weeks ago, but with limited change from the previous law.

Mr. Chairman, over the last year and one-half important discussions have taken place over ways in which the credit can be improved, and needed dialogue on the credit has been stimulated. One such important change, originating through the offices of Congressman

[1] H.R. 2264, section 14112.

Sander Levin, and supported by others on your committee, would encourage cooperative relationships, combinations of companies that perform research in teams. These favorable changes are embodied in a bill introduced by Senators Danforth and Baucus on March 26, 1993 (S. 666) and Senator Lieberman on February 18, 1993 (S. 394).

The proposed modifications will improve the credit in a fiscally responsible way. By stimulating industry-led collaborative efforts, the modification credit will maximize limited private and public sector R&D funds, and encourage firms to better allocate precious research resources to projects which advance both their individual and collective goals. The modification will also stimulate new research -- research unlikely to be undertaken individually because it is too costly, too risky or too long-term. Finally, by making efficient use of public and private R&D resources, the modification will fully and cost-effectively advancing the main policy rationale behind section 41 credit.

Through the tax code we can construct the framework for research partnerships that are truly industry-led in the most efficient manner possible. We elicit your support in enacting this important improvement to the R&E tax credit when the Conference Committee considers the credit in the coming weeks. On behalf of the Alliance, I urge the committee to adopt needed modifications to the credit as embodied in the Danforth-Baucus proposal.

I. Collaborative R&D in the U.S. is Undersupported

Real economic growth has always been dependent on development and application of new science, innovation and technology. Since the Great Depression, between 65 and 80 percent of all productivity improvements have been attributable to the use of new technology. Indeed, studies have shown that for every $1 dollar that individual businesses realize from their investment in R&D, society as a whole realizes $3 or more. High technology firms alone represent a significant importance to our Nation. As indicated in the recent OSTP study, while high technology firms comprised only 0.7 percent of all U.S. firms (excluding sole proprietorships), the importance of these firms to the economy far outstrip their numbers. They are the source of a disproportionately large share of employment sales and exports. And they are the founts of innovation from which flow much of the increases in our Nation's standard of living.

Not surprisingly, therefore, research plays an even more critical role in the competitive status of the U.S. R&D comprises a larger share of the manufacturing value of products. It is the down payment which industry and our Nation makes on its future competitiveness. Without adequate R&D, our industries will eventually lose the race for discoveries and innovations that form the basis for new products, new services, market share and ultimately, world influence.

But in the U.S. we have witnessed a disturbing trend. At a time when global competition is heightening, U.S. R&D has fallen for the first time in 20 years and more research is being conducted overseas by U.S. companies. Moreover, when our industries do make the necessary outlays, the commercialization of new technology and its assimilation into the manufacturing process are being accomplished more swiftly by our competitors.

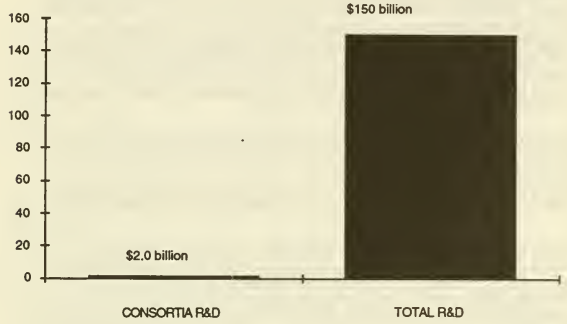
According to the National Science Board:

- *U.S. R&D stagnated in the late 1980's and continues to stagnate into the 1990's, showing a growth rate of only .4 percent, as foreign rivals increase their R&D investments.*

- *U.S. spends too few dollars on industrial R&D and makes poor use of the ones it does spend.*

- *Corporate laboratories are under severe financial stress and being forced to shift to shorter-term R&D.*

The problem is exacerbated by the increasing tendency of foreign competitors to engage in collaborative R&D. Our foreign competitors have increased their investment in research, often acting in teams which leverage their investments. In the U.S. today, approximately 200 industry consortia have been established under the 1984 Act, and new groups are forming as companies band together to face stiff global competition. However, this represents a small amount of the R&D pool. Little over 1 percent of all research is conducted cooperatively. Of the $150 billion in research and development conducted in the United States, only approximately $2 billion is conducted by consortia.[2]



By contrast, more than four times the relative percentage of R&D conducted cooperatively in Japan is collaborative, and about one-fifth of all joint research (or 6 percent of total R&D) is "horizontal" collaboration -- collaboration among competing firms. Collaborative

[2]According to a recent survey Alliance for Collaborative Research, companies conduct research and development with consortia for four major reasons: (1) to reduce the cost of conducting research by spreading the cost, (2) to reduce the risk of conducting high-tech research in untried areas, (3) to reduce redundant research within an industry -- for example, innovations needed to meet an industry-wide standard or solve a broad problem, and (4) to conduct research which will only benefit the firm after a long period. Much of this research would not be conducted without the umbrella of the consortia because of the factors above -- risk, costs, and few short term benefits.

- 35% of consortia research reduces redundancies.
- 30% of consortia research spreads risks.
- 20% of consortia research spreads costs.
- 15% of consortia research will benefit only in the long term.

European projects include ESPRIT in information technology, RACE in advanced communications, BRITE in advanced materials and manufacturing, VLSIC for high capacity memory chips, ICOT for the fifth generation computer and TRC for joint research on magnetic levitation and other technologies.

The U.S. must do more to promote cooperative research if we are to keep pace with out principal trading partners.

II. The Previous Incentives for R&D Do Not Enhance Private - Public Partnership Objectives

The Internal Revenue Code has traditionally rewarded research in three ways. The bill passed by the House would essentially retain the structure of these incentives with enhanced credits for start-up firms.

First, before its expiration on June 30, 1992, section 41 allowed a 20 percent tax credit to the extent a taxpayer's qualified research expenditures for the current year exceeded its "base." The "base" was computed by multiplying the taxpayer's "fixed-base percentage" by the average amount of the taxpayer's gross receipts for the four preceding years. Qualified research expenditures eligible for the credit included (1) "in house" expenses of the taxpayer for research wages and supplies used in research, (2) certain time-sharing costs for computer use, and (3) 65 percent of the amounts paid for contract research conducted on the taxpayer's behalf. Research outside the U.S., for social studies, arts and humanities, or to the extent provided by grants or contracts are not eligible for the credit.

Second, the Code permitted a 20 percent credit for basic research grants or awards in excess of (1) 100 percent of corporate cash expenditures paid for university basic research over (2) the sum of (a) the greater of two fixed research floors plus (b) an amount reflecting any decrease in nonresearch giving to universities by the corporation.

There are three primary policy goals that the current Section 41 credit seeks to fulfill. First, the credit is designed to stimulate new research -- research that would not otherwise be conducted in the absence of the credit. This is the fundamental reason for the incremental structure of the credit. Second, the credit is a means to balance the social rate of return, or the benefit which inures to society from R&E, with the economic benefits that inure to the individual firm. As the gap between social and economic rates is closed, market distortions against performing R&E are partly overcome. Third, the credit balances similar subsidies provided to business by our trading partners.

Third, by administrative *fiat* the Treasury Department extended Section 4009 of the 1988 TAMRA. The Revenue Procedure generally requires firms to allocate 64 percent of U.S. R&D expenses to U.S. source income and 64 percent of foreign R&D to foreign source income -- the remainder allocable by gross sales or gross income.

Fourth, Section 174 of the Code provided for current expensing of some of the R&E costs that would otherwise be chargeable to capital account.

As a result, the House proposal provides no special incentive for firms to engage in cooperative research, and may actually be biased against cooperative research. To the extent cooperative research is research above the "base" it is subject, like individual R&E, to the incremental

credit. Outside contract expenses are creditable only to the extent of 65% of these expenses.

The Danforth-Baucus proposal would modify section 41 to provide a 20 percent credit for certain cooperatively conducted research. Qualified contributions include cash, and noncash contributions to the extent of cash contributions. Qualified consortium include those with at least five contributors, if no 3 contributors contributed more than 80 percent of the total nongovernmental contributions, and no single member contributed more than 50 percent of total nongovernmental contributions.

The current treatment of contributions to research consortia is more fully covered in exhibit A.

III. Added Incentives for Cooperative R&D are Needed

There are many justifications for permitting a credit for cooperatively conducted R&D. A few of these justifications are listed below.

The Cooperative Credit Overcome An Inherently Institutional Bias Against Cooperation and a Built-in Reluctance to Cooperate

Most importantly, the credit is needed to overcome a bias against cooperative research that has been institutionalized in the American business culture. Historically, antitrust laws and our traditional image of stubborn independence have combined to characterize cooperative research not only as a sign of weakness, but as an approach that could restrict competition or trade. As a result, most American companies have been reluctant to share manufacturing information and technology, even when their problems are industry-wide and solutions are costly and risky.

The credit would be the next logical step in a series of steps undertaken by Congress to remove institutional obstacles to cooperative research. In 1984, Congress passed the National Cooperative Research Act, which was intended to assuage fears that cooperative research (through the prototype stage) violated U.S. anti-trust statutes. In addition, the Stevenson-Wydler Technology Act of 1980, the Federal Technology Transfer Act of 1986 and the Omnibus Trade and Competitiveness Act of 1988 have all increased the abilities of American companies to engage in collaborative research. Consortia pursue only jointly beneficial research, as is specifically required in the 1984 NCRA.

In addition to overcoming cultural biases, the credit is needed to overcome internal perceptions that cooperation will hinder rather than help. R&D goes to the very heart of a firm's existence. Innovation, technology, knowledge and discoveries are the lifeblood of a firm; they are the means by which a firm gains marketshare. But these commodities only have value if they are either unknown to other firms or protected under intellectual property laws.

By asking firms to cooperate on R&D, we are asking them to share with others -- mostly competitors -- some of this knowledge. Cooperative R&D is new, difficult to organize and carries substantial perceived risks to firms. For an aggressive growth company, fear of "contributing knowledge" to competitors instead of "sharing" in the new knowledge is very real. And the cooperative group activity is subject to less individual corporate control, which elevates this concern.

In sum, legitimate concerns that the release of proprietary R&D to competitor firms through disclosure will override other benefits contributes to an enhanced reluctance to engage in cooperative research. The cooperative R&E tax credit becomes an offset against such concerns and provides an additional tool for enhancing international technology competitiveness.

The Cooperative Credit Furthers Sound Policy Goals of the Incremental Section 41 Credit

The cooperative R&E tax credit strongly advances the policy justifications of the section 41 incremental credit, and at the same time, rewards the most efficient use of limited R&D funds. The cooperative credit has much to recommend it: to the extent the credit leverages research dollars it encourages more efficient use of limited R&D resources; to the extent it spreads risks and costs it encourages new research that would not be conducted in its absence; and, to the extent it eliminates redundant research, it increases the stimulate effect of the existing tax expenditures.

First, the cooperative R&D tax credit will stimulate new R&D (as the incremental Section 41 credit is intended to do). This is because the credit enables firms to spread risks and costs by pooling cash, in-kind contributions, scientists and technical know-how on R&D that would otherwise be too costly, too risky or too long-term to perform individually.

Second, the cooperative credit will advance the underlying goals of Section 41 by ensuring the research is conducted in the U.S. and by better enabling firms to meet foreign competition. The collaborative R&D tax credit is intended not only to help firms compete against one another, but to band together to meet global competition.

Beyond existing policy goals, cooperation offers a cost-effective alternative to otherwise duplicative R&D, such as R&D conducted to meet safety, environmental or health standards. When firms are able to collaborate on research, they can make the most judicious use of limited R&D dollars. And since cooperative research enables firms to more wisely and effectively use limited R&D resources, a collaborative R&D credit can work in conjunction with the Section 41 credit to allow the incremental credit to apply more efficiently to firm-specific research.

The Credit Will Benefit Firms Not Encouraged by the Current Incremental Credit

Direct benefits of the proposed enhancement to the R&E tax credit will undoubtedly inure to the bottom line of companies that conduct cooperative research. The cooperative credit will assist companies that are otherwise increasing their R&E expenditures above the "base," regardless of how that base is defined in the section 41 incremental credit. Equally important, however, it will also benefit companies that cannot take immediate advantage of the incremental credit either because they do not have taxable income against which the credit can be offset, are subject to the limitations of the Alternative Minimum Tax or whose R&D falls below the base. It also includes smaller firms who may be disinclined to invest the needed amounts in process or other technologies not perceived to immediately inure to the bottom line, but in the long run are key to their sustained competitiveness.

The ability to share in the research results of cooperative research that is "incentivized" or encouraged by the enhanced credit is a direct benefit that will inure to all participants in a cooperative venture. In other words, because the research is cooperatively conducted (and financing is interrelated), lowering the costs of capital outlays lowers the cost of capital for the research venture in its entirety. In essence, the leveraged research is disseminated to small and large firms alike, profitable and currently nonprofitable firms alike, and the indirect benefit of the credit is spread to the entire membership of the project. For firms that are below the "base", cooperation will allow them to "catch up to the fold" with immediately rewardable R&E expenditures.

The Credit Will Efficiently Stimulate R&D to the Benefit of the Public and the Public Fiscal Interest

A common test of the utility of the credit has always been how much research it stimulates, but this is far from a perfect criterion. A more correct measure of the utility of an R&E tax credit is how efficiently the credit promotes research, how quickly it facilitates dissemination of research results, and how effectively it assists in the commercialization of innovations within short time frames. The credit not be judged simply by how much R&D dollars it stimulates, but by the knowledge conveyed and deployed by the R&D performing firm.

The cooperative R&D tax credit induces new research at lower costs to limited public resources (in the form of tax expenditures) and lower costs to increasingly limited private resources. It helps companies make more efficient use of limited resources by overcoming transactional and cultural barriers to cooperation, providing a counterbalance to perceived or real disadvantages from disclosure of information. Moreover, it will reduce redundant research on which the incremental credit is now taken, ensure innovations are considered for the widest possible application, enable U.S. companies to bring technology to market faster on a wide variety of applications by involving more partners and employ teamwork to meet new challenges in the global trade environment.

The savings of finite public and private sector R&D resources and the new generation of R&D activity will inure to the benefit of the consumers in safer, more economical and more efficient products of greater variety.

Cooperation Advances The Starting Point for Competition

Consortia greatly heighten competition within industry. They do so by increasing the availability of technology and the speed with which technology is distributed among small and large firms, placing businesses within the industry on a more equal footing. Leveraging R&D funds in collaborative efforts also frees up competitive energies by enabling firms to concentrate on firm-specific R&D, and by increasing the number of firms that have access to new manufacturing processes and technologies.

Stated another way, when a significant portion of an industry, or competitive base is aware of best methods, best processes or technological advances, the technology is quickly dispersed throughout the field of competitors, reducing relative competitive advantages. As the technology is commercialized and integrated into the products and processes, it improves the efficiencies and technology of all competitors. No competitor, therefore, can use this knowledge alone to gain competitive advantage, unless it is able to do so through application and development. As a result, the credit will

cause competitors to advance their starting line for a particular market, heightening competition among the firms in the team for the benefit of the consumer and U.S. industry. The price for advancing the starting line among competitors is a greater inducement to do so.

The Credit Will Close the Wider Gap Between Societal and Economic Returns

It is generally recognized that firms will underinvest in R&D. The prospect of recapturing income from a new idea is the primary incentive for commercializing new products or developing new processes. But individuals or firms that undertake R & D of new technologies must always balance the prospect of return with the cost of that R&D, the risk of failure and the consideration that, even if they are successful, they will not be able to reap the profits attributable to the new technology.[3] A firm that is efficient in finding new technologies is not always poised to best manufacture and distribute the product, or otherwise fully capitalize on that technology. In short, firms have difficulty capturing the benefits of research to the same extent those benefits inure to society.

The R&D tax credit is partly meant as a means to balance this market distortion by bridging the gap between the social rate of return and the economic rate of return to the individual firm. To the extent the gap between social and economic rates is closed, actual market forces can work more effectively to properly allocate sufficient funding to R&D. The credit also counters similar incentives provided for by our competitor-nations.

In cooperative research, however, even greater gaps between economic income and the social rate of return are present, and even greater competitive pressures come to bear. The greater gap between societal and individual rates of return stem from two factors: first, that the social rate of return is higher per dollar of R&D expended; second, that the firm has greater difficulty recapturing investment. As noted, because companies are sharing research results with competitors -- even if the consortia involves vertical components -- the starting line for competition is advanced for all participants. No individual firm, therefore, gains relative advantage over another in the cooperative research. This inability to recapture relative income gain widens the gap between the firm's perceived individual return, and the benefit to the public. The cooperative R&D tax credit modification is meant to stimulate two principal policy goals of the Section 41 credit: (1) it is intended to stimulate new research, and (2) it enables firms to recapture the economic profits of R & E outlays, when these are most difficult to be recaptured.

The Credit Will Allow For Truly Industry-led Cooperation in a Public - Private Partnership

The Congress, through direct funding of research consortia, has already reached the decision that substantial Federal resources are required to overcome the newness of cooperative research, fear of disclosure, cultural biases, and transactional costs stemming from organizational difficulties. The tax credit would be a continuation of this policy, and more: it would allow industries to decide which cooperative ventures ought to be funded, and enable the government to indirectly participate in that decision. But a tax credit will enable

[3]While research may result in large dividends to firms that conduct such research, such firms are reluctant to conduct research because of the long-term nature of the rewards and because of the fear that the innovation or new processes developed from this research will be lost to competitors.

industry to decide which research projects it needs to pursue to meet foreign competition. Industry is in the best position to see what arrangements will be needed to meet new challenges.

The Credit Will Change the Paradigm of R&D

When American technology ruled the world, means of improving not just the technology, but the process for creating it, had little place in the public agenda. America is now threatened in the global race for economic dominance by competitors that understand the efficiency of collaboration.

That research done cooperatively may lead to overall efficiencies does not mean that companies will correctly perceive these efficiencies. By stimulating industry-led collaborative efforts, a credit will allow individual firms to perceive a direct advantage in cooperating, and force the construct for cooperation.

The Credit Redress Certain Inequities

The tax credit for consortia research is also needed because the Code can treat cooperative research disadvantageously. As previously discussed, outside contract expenses are currently creditable, if at all, to the extent of 65 percent. Therefore, contributions to research consortia are not fully creditable as in-house expenses. This 65 percent contract limitation is not without an ostensible policy goal: it is meant to reflect the cost of in-house research overhead, and therefore, equalize the treatment between in-house and contracted research. However, the reasoning behind the policy is flawed: it is precisely the lower overhead costs of research consortia and the higher return per dollar of contribution which recommends cooperative research.

The Credit Will Advance the Starting Line for Competition

In today's world, maintaining latest technology is not just a question of market share, it is a question of survival. In technology-intensive industries, failure to keep up with technological advances will have immediate repercussions, not only for the firms involved, but for the entire U.S. industry. The motivation for individual research, to pull out from the pack, is not quelled by the knowledge of what others know. Sharing knowledge only makes competitors aware of where their competition is and of where they need to excel individually.

Conclusion

Mr. Chairman: Today's crowded, international marketplace has imposed a new reality on American business -- a wake up call that is audible to every sector of our Nation's industrial base. Today U.S. businesses no longer battle for domestic market shares, but fight to survive in the global marketplace. And while they compete against each other, our foreign competitors have learned to achieve results faster and more efficiently through collaboration.

Nowhere perhaps is this collaboration more critical than in the performance of Research and Development.

It is time for a domestic tax policy that rewards R&D conducted cooperatively as part of our current tax incentive system for R&D. As the credit leverages research dollars it encourages more efficient use

of limited R&D resources. As the credit spreads risks and costs it encourages new research that would not be conducted in its absence. As the credit eliminates research that would otherwise be conducted -- duplicative research -- it reduces the tax expenditure. These reasons recommend that national tax policy reward collaborative R&D.

American industry faces its greatest challenge in nearly a century. The events of the last decade have reconfigured the world, a world where global influence is not measured by the number of warheads but by economic prosperity. One key to meeting this challenge is creating an environment for industrial cooperation. The collaborative R&D tax credit is intended not only to help firms compete against one another, but to help entire industry sectors meet global competition.

Exhibit A:

The Current Treatment of Contributions to Cooperative Research Organizations Under the Internal Revenue Code (Code).

Whether or not contributions to cooperative research organizations (or expenses relative to cooperative projects) are creditable under Section 41, and to what extent they are creditable, depends upon several factors. First, if the entity is a pass-through entity, such as a partnership, in order to be creditable at all either the taxpayer must be engaged in the trade or business to which expenses relate (usually the case in cooperative research) or the partnership must be engaged in the trade or business to which expenses relate. Second, if the taxpayer contracts outside employees to conduct research (assuming the research relates to the trade or business of the taxpayer), the taxpayer can apply the credit only to the extent of 65 percent of the qualifying research and experimentation (R&E) expenditures. Third, if the taxpayer structures the arrangement as a joint venture or a partnership, the taxpayer will generally not be subject to the 65 percent limitation and may treat the expenses as fully creditable (as in-house) expenses. If the entity is a partnership, the expenses will be passed through, provided the entity is conducting a trade or business to which the research relates at the partnership level. If the entity is not conducting a trade or business, but the partner can independently use the results of the research, the credit is determined by an equitable formula, taking into account partnership distributions.

Discussion:

I. In-House Research

The Code provided several incentives for industry-initiated research -- the most important being the credit under Section 41.[4] Until its expiration on June 30, 1992, the credit for in-house research and experimentation (R&E) was 20 percent of the excess of current year R&E expenditures over the "base" -- the product of the average of four preceding taxable year's gross receipts and the ratio of the aggregate qualified research for 1983 to 1989 to gross receipts in those years.[5]

II. Cooperative Research

Although direct appropriations often provide the current incentive for specific cooperative research projects and consortia, before its expiration Section 41 provided no direct incentive for firms to engage in industry-to-industry cooperative research beyond the R&E tax credit (although university basic research was provided as incentive). Indeed, research conducted through cooperative research organizations is

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[4] Another temporary provision is intended, in part, to favor R&E conducted in the U.S. Under the U.S. worldwide taxing system, to the extent expenses are allocable to foreign source income, the U.S. taxpayers have a smaller foreign tax credit and a larger domestic tax liability. For this reason, U.S. taxpayers prefer expenses allocated to U.S. source income. Section 4009 of the Technical and Miscellaneous Revenue Act of 1988 lowers the effective worldwide tax rate of U.S. firms by generally requiring firms to allocate 64 percent of U.S. R&D expenses to U.S. source income and 64 percent of foreign R&D to foreign source income -- the remaining R&D to be allocated on the basis of gross sales or gross income.

[5] This is expressed as follows:

$$CYR\&E - [(GRPY1 + GR2ndPY + GR3rdPY + GR4thPY)/4 * (1983R\&E + 1984R\&E + 1985R\&E + 1986R\&E + 1987R\&E + 1988R\&E + 1989R\&E)/(1983GR + 1984GR + 1985GR + 1986GR + 1987GR + 1988GR + 1989GR)],$$

where PY = preceding year, GR = gross receipts, CY = current year. The base is determined separately for start-ups, which are given a fixed base percentage of 3 percent. The base amount for any firm, start-up or established, cannot be less than 50 percent of the qualified expenditures for the current year. This limitation establishes an effective ceiling on the credit for high-growth companies. As you know, the 103d Congress is exploring ways in which this base calculation, which has proven unsatisfactory to many companies, can be improved.

subject to different rules than research conducted in-house, and when the rules are the same, the application of these rules have different ramifications. The following discusses the treatment of contributions to cooperative research organizations.

A. Forms of Cooperative Research Projects

Cooperative research projects can take several forms. One form is the typical consortia scenario, where member companies (those companies participating in a project) provide funding to a 501(c)(3) organization which then uses the funding to oversee the project. The 501 (c)(3) can utilize facilities at its member companies, at the consortia itself or can contract with any other outside organization. Another form is where the members companies establish either an S corporation or a C corporation to conduct the research activity. In another form, the companies establish a general or limited partnership with a corporation, the consortia, which operates as the general partner. Yet another form is where the companies merely establish a joint research venture. In the colloquy of cooperative research they are referred to, for example, as:

- *R & D Sponsored Pools, where members pool their funds to sponsor research at universities and other institutions.*
- *Basic Research Cooperatives, which concentrate on risky research not otherwise undertaken by individual members.*
- *Equity joint ventures, where the firms share the financing, ownership, risks and returns.*
- *Non-equity joint ventures, which largely include cross-licensing agreements.*

B. The "Trade or Business" Restriction

The creditability of contributions for cooperative research -- whether these combined contributions are made in the form of a joint venture, through a partnership, to a C corporation or S corporation (nonprofit or for-profit, including a federally funded research consortium), or other entity -- primarily depends on application of the "trade or business" requirement. In order to qualify for the credit, all "in-house" or "contract research " must be paid or incurred in carrying on a trade or business."[6]

The "trade or business" restriction ensures "the principal purpose of the taxpayer in making such expenditures is to use the results of the research in the active conduct of the trade or business." The restriction seeks to prevent, rather than reward mere financiers of the project with a credit designed to offset costs of development.[7] Exceptions to this requirement are "basic research" (the advancement of scientific knowledge not having a specific commercial objective),[8] and "start-up" expense (when the company contemplates using the research in a future trade or business).[9] The trade or business requirement is met, therefore, if at the time such expenses are incurred, the taxpayer intends to use the results of the R&E in the active conduct of an existing or future trade or business.[10]

As businesses cooperate on research projects three factual scenarios can occur: (1) a partnership or other pass through entity of parent companies incurs or pays research expenses in carrying on a trade or business (2) a partnership or other pass-through entity of parent companies incurs or pays research expenses but does not carry on a trade or business, (3) the companies that seek to conduct cooperative research pool funds together and contract out research, without utilizing the participating companies employees, supplies or noncash resources.

In application to a pass-through entity, the trade or business requirement generally yields three rules:

- *If at the pass-through entity level the R&E expenses (whether contracted for or conducted in-house) are paid or incurred in carrying on a trade or business,*

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[6]Section 41(b)(1). Stemming from section 162, this subsection provides:

> *The term qualified research expenses means the sum of ... in carrying on any trade or business of the taxpayer.*

[7] Section 41(b)(4).
[8] Basic research is automatically considered as qualifying under Section 41(e)(7).
[9]Section 41(b)(4).
[10]Conference Report, P.L. 101-239, 1989 OBRA.

then the expense is fully creditable, regardless of the trade or business of the partners or venturers.[11]

- *If at the entity level, the qualifying R&E expense is not paid or incurred in carrying on a trade or business, the expense is generally not creditable to the partners or venturers.*

- *However, given the above, if all the partners of venturers are entitled to make independent use of the results of the research, such expenditures can be treated as qualified research expenditures by certain partners or venturers.*

C. How the Cooperative Research Is Conducted

1. The Partnership, S corporation or Venture Pays or Incurs the Qualifying R&E in Carrying on a Trade or Business

An in-house research expense or a contract research expense paid or incurred by a partnership is a qualified research expense of the partnership, if the expense is paid or incurred by the partnership in carrying on a trade or business of the partnership, determined at the partnership level without regard to the trade or business of any partner.[12] In the case of a partnership, the research credit is apportioned among the persons who are partners in accordance with Code section 704. For example, since the credit is an expenditure credit, it is to be apportioned on the same basis as the Code section 174 expenses.

Similar rules apply in the case of an S corporation. In the case of an S corporation, the amount of the research credit shall be allocated to the shareholders according to the provisions of Code sections 1366 and 1377.[13]

2. The Partnership, or Venture Does Not Pay or Incur the Qualifying R&E in a Trade or Business in Carrying on a Trade or Business

If a partnership or a joint venture (taxable as a partnership) is not carrying on the trade or business, such expenditures will not generally qualify as qualified research expenses. Consequently, no credit will be available to the partners or venturers. However, under an exception, if all the partners are entitled to make use of the results, such expenses may be qualified to the partners or venturers, provided they could be taken by the partners or venturers in their individual capacities.[14]

Determining the amount of the credit under this exception takes several steps. The amount of the credit available to the partners or joint venturers is determined assuming the partnership or joint venture is carrying on the trade or business to which the research relates. This amount is then reduced by the proportionate share of such expenses allocable to those partners or venturers who would not be able to claim such expenses as qualified research expenditures if they had paid or incurred such expenses directly. For this purpose, such partners' or venturers' proportionate share of such expenses shall be determined on the basis of such partners' or venturers' distributive share of partnership items of income or gain.[15]

The remaining amount of qualified research expenses is allocated among those partners or venturers who would have been entitled to claim a credit for such expenses if they had paid or incurred the research expenses in their own trade or business, in the relative proportions that such partners or venturers share deductions for expenses under section 174 for the taxable year that such expenses are paid or incurred.[16]

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[11] But see discussion on whether the research is fully funded.

[12] The phrase "in carrying on a trade or business" has the same meaning for purposes of section 41(b)(1) as it has for purposes of section 162; thus, expenses paid or incurred in connection with a trade or business within the meaning of section 174(a) (relating to the deduction for research and experimental expenses) are not necessarily paid or incurred in carrying on a trade or business for purposes of section 41.

[13] Regulation section 1.41-9.

[14] Regulation section 1.41-2.

[15] Where a partner's or venturer's share of partnership items of income or gain (excluding gain allocated under section 704(c)) may vary during the period such partner or venturer is a partner or venturer in such partnership or joint venture, such share shall be the highest share such partner or venturer may receive.

[16] For purposes of section 41, research expenditures shall be treated as paid or incurred directly by such partners or ventures.

3. *The Companies That Pool Funds and Contract Out*

Two Restrictions Apply

Firms that contract out research are subject to two restrictions. First, section 41(b) of the Code rewards contract research expenditures, but defines the term "contract research expenses" to mean 65 percent of any amount paid or incurred by the taxpayer to any person (other than an employee) to conduct qualified research.[17] To the extent cooperative research is research above the "base" it is eligible, like individual R&E, for the incremental credit.

Second, if any contract research expenses paid or incurred during any taxable year are attributable to qualified research to be conducted after the close of the taxable year, such amount shall be treated as paid or incurred during the period in which the qualified research is conducted.[18]

Qualifying R&E Costs

Under normal rules for in-house research, qualified research costs include costs for supplies and personal property used in the conduct of qualified research.[19] Expenditures for supplies or for the use of personal property that are indirect research expenditures or general and administrative expenses do not qualify as in-house research expenses.[20]

Most significantly, however, wages paid for "engaging in qualified research are creditable".[21] The term "engaging in qualified research" means the actual conduct of qualified research (as in the case of a scientist conducting laboratory experiments), direct supervision of research or direct support. "Direct supervision" means immediate supervision or first-line management of qualified research.[22] "Direct support" means services in the direct support of either persons engaging in actual conduct of qualified research, or persons who are directly supervising persons engaging in the actual conduct of qualified research.[23]

How Much of the Wages Are Creditable?

Wages paid to or incurred for an employee constitute in-house research expenses only to the extent the wages were paid or incurred for qualified services performed by the employee. If an employee has performed both qualified services and nonqualified services, only the amount of wages allocated to the performance of qualified services constitutes an in-house research expense.[24] However, if substantially all of the services performed by an employee for the taxpayer during the taxable year relate to qualifying R&E costs, all the taxpayer's wages can be considered as qualifying R&E. As a general rule, services constitute substantially all of the services performed by the employee during a taxable year, if the wages for R&E constitute at least 80 percent of the wages paid to or incurred by the taxpayer for the employee during the taxable year.

The Effect of the 65 Percent Limitation

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[17]If contract research is performed partly within the United States and partly without, only 65 percent of the portion of the contract amount that is attributable to the research performed within the United States can qualify as contract research expense (even if 80 percent or more of the contract amount was for research performed in the United States).

[18]Section 41(b)(3).

[19]Supplies and personal property are used in the conduct of qualified research if they are used in the performance of qualified services by an employee of the taxpayer (or by a person acting in a capacity similar to that of an employee of the taxpayer).

[20]Additionally, qualified expenses may include certain utility charges, right to use personal property and the use of personal property in taxable years.

[21]Code section 41(b)(2)(B).

[22]As in the case of a research scientist who directly supervises laboratory experiments, but who may not actually perform experiments.

[23]For example, direct support of research includes the services of a secretary for typing reports describing laboratory results derived from qualified research, of a laboratory worker for cleaning equipment used in qualified research, of a clerk for compiling research data, and of a machinist for machining a part of an experimental model used in qualified research.

[24]In the absence of another method of allocation that the taxpayer can demonstrate to be more appropriate, the amount of in-house research expense shall be determined by multiplying the total amount of wages paid to or incurred for the employee during the taxable year by the ratio of the total time actually spent by the employee in the performance of all services for the taxpayer during the taxable year.

The limitation on 65 percent of qualified research activity is meant to reflect an arbitrary allocation -- 35 percent -- which would not otherwise constitute creditable expenses. Whether or not this arbitrary allocation is fair, of course, depends on the nature of the expenses relative to research.

That "substantially all" of the services performed by an employee can qualify all of the employees wages for the credit, including the additional 20 percent, seems to indicate an even greater disparity between outside research and in-house research. While 65 percent of the outside contact expenses are always limited, as much as 125 percent of employee wages are creditable (100 percent/80 percent), almost twice the outside contract expense limitation.

It is perhaps this inequity that has caused companies to seek to circumvent the rule by utilizing their own employees or their own supplies in a joint venture or partnership context. This artificial restriction distorts otherwise market-oriented decisions on the best use and form of research resources. This disparity is further enhanced by the fact that many smaller firms, that may tend to contract out, do not have nonqualifying fringe benefits if the research is done in-house (which would not qualify for the credit). To bring cooperative research into parity with in-house research, as much as 125 percent of the expenses would have to be creditable, depending upon the circumstances.

Treatment of Expenses if The Research is Partly Federally Funded

Whether or not the entity itself is qualified to take the credit depends on two factors: (1) whether the research is funded by grant or contract, and (2) whether the products of the research -- the technical knowledge -- are licensed by the consortia, partially owned by the consortia, or the exclusive property of participating member companies to the project.

Retention of Rights

If the taxpayer performs research on behalf of another person and retains no substantial rights to the research, that research is not properly taken into account by the taxpayer for purposes of section 41.[25] In sum, if the taxpayer, in carrying on a trade or business, performs research on behalf of other persons but retains substantial rights in the research, the taxpayer can take otherwise qualified expenses for that research into account for purposes of section 41.[26]

If a taxpayer performing research for another person retains no substantial rights to research under the agreement providing for the research, the research is treated as fully funded. No expenses paid or incurred by the taxpayer in performing a research agreement that confers on another person the exclusive right to exploit the results of the research is creditable.[27] If a taxpayer performing research for another retains no substantial rights in the research and if the payments to the researcher are contingent upon the success of the research, neither the performer nor the person paying for the research is entitled to treat any portion of the expenditures as qualified research expenditures.

If a taxpayer performing research for another person retains substantial rights in the research under the agreement providing for the research, the research is funded to the extent of the payments (and fair market value of any property) to which the taxpayer becomes entitled by performing the research.[28] Normally, the taxpayer shall reduce by the amount of funding the amount paid or incurred by the taxpayer for the research that would constitute qualified research expenses of the taxpayer.

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[25] See 1.41-5(d)(2).

[26] But may do so only to the extent described in section 1.41-5(d)(3). See below discussion.

[27] Incidental benefits to the taxpayer from performance of the research (for example, increased experience in a field of research) do not constitute substantial rights in the research.

[28] A taxpayer does not retain substantial rights in the research if the taxpayer must pay for the right to use the results of the research.

If the taxpayer establishes to the satisfaction of the IRS the total amount of research expenses (that is, the expenses which would be qualified research expenses if there were no funding) exceed 65 percent of the funding, then the taxpayer may allocate the funding pro rata to nonqualified and otherwise qualified research expenses. In no event, however, shall less than 65 percent of the funding be applied against the otherwise qualified research expenses. These provisions are applied separately to each research project undertaken by the taxpayer.

Mr. PAYNE. Thank you very much, Mr. Sumney. If you would remain with the panel until we have heard from the final witness, then perhaps we would have questions for each of you.

I would at this time like to recognize my colleague, Mr. Kopetski, for the purpose of an introduction.

Mr. KOPETSKI. Thank you, Mr. Chairman. I am pleased to introduce Bob Gregg, the vice president of finance and CFO for Sequent Computer Systems. This is a company located in Portland, Oreg., which designs and manufactures computer systems.

Mr. Gregg is appearing before the subcommittee today to testify about a provision to change the definition of startup companies for purposes of the R&D credit. This issue is of particular importance at this time because we in the full committee and in the House have voted to make the R&D credit permanent. Sequent Computers and a very few other companies cannot take advantage of the R&D credit strictly due to the year in which they began their operations. Someone has suggested that the companies with this problem be known as the notch babies of the R&D credit. I will let Mr. Gregg elaborate on that point. Thank you, Mr. Chairman.

Mr. PAYNE. Thank you.

STATEMENT OF ROBERT S. GREGG, VICE PRESIDENT OF FINANCE, TREASURER, AND CHIEF FINANCIAL OFFICER, SEQUENT COMPUTER SYSTEMS, INC.

Mr. GREGG. Mr. Chairman and members of the subcommittee, I am here today to testify on the provisions to correct the original definition of startup companies, as it was initially intended for purposes of the R&D credit. This provision was included in H.R. 11 last year as passed by the Congress and vetoed by President Bush. It is also included in S. 666. I want to thank this committee for providing me the opportunity to testify on behalf of Sequent as well as the American Electronics Association.

In addition, I would like to submit for your consideration written testimony from Sierra Semiconductor, another AEA member with this concern. Sequent is a midsized company located in Portland, Oreg. Largely due to the research and development undertaken by Sequent to design and manufacture a new generation of large commercial computer systems which have come to be known as symmetric multiprocessing computers, we have grown the company from $400,000 in sales in 1984 to over $300 million in 1992.

The company was founded in 1983 by 18 former employees of Intel Corp. with a vision of the future, the very type of innovative spirit that the research and development credit was designed to encourage and reward. As a result of a technical glitch in the credit rules, Sequent is not entitled to a research credit for any year after 1990, although our R&D efforts continue to grow as we design products which will take the company into the 21st century.

To very briefly give you some background, under the current credit only qualified research expenses over a fixed base amount are eligible for the credit. In 1989 the base calculation was changed so that the base is now computed by multiplying the ratio of the company's qualified research expenses to gross receipts for 1984 through 1988 by the company's average gross receipts in the immediate preceding 4 years.

Recognizing that companies in the startup phase will experience a distorted relationship between the research expenses and gross receipts and in their initial years of operation, Congress provided a special fixed base for startup companies. Specifically under those rules, a startup company is defined as any company with fewer than 3 years of both gross receipts and qualified research expenses during the base period, which was 1984 to 1988.

The problem with the 3-out-of-5-year test is that it by definition erroneously misses any company that began during the early years of the base period as contrasted with those starting in later years of that period or thereafter. As such, any company with its first year of both gross receipts and R&D falling in 1984, 1985, or 1986 will not be considered to be a startup company even though its R&D to sales ratio could have been well beyond 100 percent during those early base years.

We understand from those involved in putting the provision together in 1989 that this result was certainly not intended. Sequent incurred its first year of research costs in 1983 and its first year of gross receipts in 1984. As a result, our fixed base percentage is so high that for all of this foreseeable future we will not receive an R&D credit, yet our history and our R&D to sales ratio show that we are clearly in a startup phase and thus we are the type of company Congress intended to include in the future credit eligibility.

Without the change, the credit's incentive value is zero for companies like Sequent. More important, the current startup company definition puts Sequent at a significant disadvantage when we try to compete with other already established companies or even a new company. Either of these companies will get a 20 percent incentive for their extra R&D they spend in developing the next product. We, in contrast, will get nothing.

The proposal that solves this problem is very simple. It would change the definition of a startup company to include any company with its first year of both R&D and sales in 1984 or thereafter. So if I could summarize, because of the oversight in 1989 tax legislation with respect to the startup definition, Sequent is at a competitive disadvantage and the credit is a failure. We ask that you acknowledge this oversight and support the proposal to put Sequent and other companies like us on a level playing field once again.

It cannot be good tax policy to keep a provision in place when it penalizes young, but rapidly growing, companies that are bringing new technologies to market to win against the growing foreign competition. Unlike many other industries where market leadership has been seized by foreign competition, the computer systems and software industry continues for the time being to be led by U.S.-braced companies. It is innovative leading edge technology companies like Sequent that are helping make this possible.

The R&D tax credit was originally put into place to achieve this result, and I ask you not to let a technical oversight in the law render it meaningless. I would be happy to answer any questions.

[The prepared statement follows:]

STATEMENT OF ROBERT S. GREGG

VICE PRESIDENT OF FINANCE, TREASURER AND CFO
FOR
SEQUENT COMPUTER SYSTEMS, INC.

RESEARCH AND DEVELOPMENT CREDIT
START-UP COMPANY PROVISION

COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

JUNE 22, 1993

Mr. Chairman and Members of the Committee. My name is Bob Gregg. I am the Vice President of Finance, Treasurer and Chief Financial Officer of Sequent Computer Systems. I am here today to testify on the provision to correct the original definition of start-up companies as it was initially intended for purposes of the R&D credit. This provision was included in H.R. 11 last year, as passed by Congress, and vetoed by President Bush.

I want to thank this Committee for providing me the opportunity to testify on behalf of Sequent as well as the American Electronics Association (AEA).

In addition, I would also like to submit for your consideration written testimony from Sierra Semiconductor, another AEA member with this concern.

Sequent is a mid-sized company located in Portland, Oregon. Largely due to the research and development undertaken by Sequent to design and manufacture a new generation of large commercial computer systems (which have come to be known as symmetric multi-processing computers), we have grown the company from $400,000 in sales in 1984 to over $300 million in 1992.

The Company was founded in 1983 by 18 former Intel employees with a vision of the future, the very type of innovative spirit that the research and development credit was designed to encourage and reward. As a result of a technical glitch in the credit rules, however, Sequent is not entitled to a research credit for any year after 1990 although our R&D efforts continue to grow as we design products which will take the Company into the 21st century.

BACKGROUND: Under the current credit, only qualified research expenses over a fixed base amount are eligible for the credit. In 1989 the base calculation was changed so that the base is now computed by multiplying the ratio of a company's qualified research expenses to gross receipts for 1984-1988 by the company's average gross receipts in the prior four years.

Recognizing that companies in a start-up phase will experience a distorted relationship between research expenses and gross receipts in their initial years of operation, Congress provided a special fixed base for start-up companies. Specifically, under those rules a start-up company is defined as any company with fewer than

3 years of both gross receipts and qualified research expenses during the base period (1984-1988).

PROBLEM: The problem with this three out of five year test is that it necessarily misses any company that began during the early years of the base period, as contrasted with those starting in the later years of that period or thereafter. Indeed, any successful company that starts selling or starts R&D in the early years of that period would not have stopped R&D spending or sales during the later years of that period. As such, any company with its first year of both gross receipts and R&D falling in 1984, 1985 or 1986, will not be considered to be a start-up even though its R&D to sales ratio could have been well beyond 100% during many of the base years. We understand from those involved in putting the provision together in 1989 that this result was certainly not intended.

Sequent is a perfect example of the unfairness exacted by this rule. Like many companies in the early 1980's, Sequent was funded by venture capital. This initial capital allowed the founders of the company nearly two years to develop a marketable product without the immediate need to generate revenue to cover operating costs. As a result, in these early years of operations, the Company's R&D as a percentage of sales was extremely high, in some years, well over 100%.

Sequent incurred its first year of research costs in 1983 and its first year of gross receipts in 1984. As a result, our fixed base percentage is so high that for all of the foreseeable future we will not receive any R&D credit. Yet our history and our R&D to sales ratio show that we were clearly in a start-up phase and thus, were the type of company Congress intended to include in future credit eligibility.

Without This Change The Credit's Incentive Value is Zero For Companies Like Sequent: The purpose of the credit is to cause companies to spend more on R&D than they otherwise would without the credit. This increased R&D effort is supposed to be beneficial to society because companies like Sequent will be better able to bring new and more efficient technologies to society. In Sequent's case however, the credit is a complete and total failure. We will simply never get any R&D credit because of this start-up company definition.

The Credit Actually Puts Sequent At a Competitive Disadvantage Vis-a-Vis its Competitors: More importantly, the current start-up company definition puts Sequent at a significant disadvantage when we try to compete with an already established company, or a new company. Either of these companies will get a 20% incentive for the extra R&D they spend in developing that next generation of product. We, in contrast, will get no help.

The high technology industry has evolved and changed over the 10 years since Sequent began business. The one overriding main stay in surviving in the market place is having a competitive edge. Without an R&D credit, Sequent will be a distinct disadvantage against our competitors due to our misfortune of having our first year of sales and R&D fall in 1984, rather than 1987 or beyond.

Since 1984, our revenues have grown from $400,000 to over $300,000 million, close to one-half of which is shipped into international free-trade markets. In addition, our research expenses have grown over 700% to over $50 million annually. The old formula research credit has provided Sequent and other young companies like us the necessary incentive to perform research and development and has allowed us to stay ahead of our foreign competition in the computer systems business. The R&D credit has a direct and clear impact on our future investment in research and it is critical that a technical glitch in the definition of a start-up company not put us at a competitive disadvantage.

PROPOSAL: The proposal that solves this problem is very simple. It would change the definition of a start-up company to include any company with its first year of both R&D and sales in 1984 or thereafter.

Moreover, the proposal would not give us an unusually generous benefit. Rather than being subject to the special start-up company rules forever, the proposal would actually only provide a special rule for Sequent for one year, after which our actual permanent percentage would be based on our 6th through 10th year. This latter period is far more representative of the level of R&D to sales ratio that our company will strive to maintain. As such, it would provide a significant incentive for our company to increase our level of R&D spending and keep us competitive.

CONCLUSION: Sequent is doing business in a rapidly changing market place in an industry where having a competitive advantage can mean the difference between success and failure. Because of the oversight in the 1989 tax legislation with respect to the start-up definition, Sequent is at a competitive disadvantage and the credit is a failure. We ask that you acknowledge this oversight and support this proposal to put Sequent and other companies like us on a level playing field once again. It cannot be good tax policy to keep such a provision in place when it penalizes the young but rapidly growing companies that are bringing new technologies to market to win against growing foreign competition.

Unlike many other industries where market leadership has been seized by foreign competition, the computer systems and software industry continues, for the time being, to be led by U.S. based companies. It is innovative, leading edge technology companies like Sequent that are helping make this possible. The R&D tax credit was originally put into place to achieve this result. I ask you to not let a technical oversight in the law render it meaningless.

I would be happy to answer any questions you may have.

Chairman RANGEL. To Mr. Mayer and Ms. Cahan, as relates to the 42d Street project, as you know, I support it as the mayor supports it and the Governor. Recently I had an opportunity to take many Members of Congress to New York. They understood the importance of this landmark and tourist attraction. They understood that it is important to major cities throughout the country to be able to preserve these sites. You were here, I assume, when Treasury opposed the rifle shot?

How would you explain to Treasury as to why 7 years is not enough, as Treasury put it, that you were given the opportunity, you were given a transition rule and now we find ourselves asking for another extension?

Mr. MAYER. Thank you, Mr. Chairman. I recall that the Assistant Secretary commented that this is not an appropriate time to extend the tax incentives afforded the project, yet it isn't clear to Times Square Center Associates when an appropriate time would occur.

Chairman RANGEL. I asked him if it would be an appropriate time, and he thought the appropriate time had expired.

Mr. MAYER. The problem, sir, is that the timetable for development of the project has drastically changed, but not as the fault of anything that the developer or the City of New York or the State of New York has done. We have invested more than $250 million——

Chairman RANGEL. What caused us not to make that timetable so that I will be better equipped to deal with Treasury?

Mr. MAYER. The revenue analysis shows there is no cost if the incentive——

Chairman RANGEL. I understand that. You understand what they are saying?

Mr. MAYER. Right.

Chairman RANGEL. They call this privileged legislation, so obviously we have to show hardship, and I am just asking that—I know that substantial moneys have been invested. I just wonder why did we not meet the mark?

Mr. MAYER. I think the critical matter was the 46 lawsuits that were brought to stop the project. Each one of them was dismissed on motion, no trials, but it still took more than 5 years to resolve them.

Chairman RANGEL. All right. Now, I have been telling some people that have been seeing me on behalf of the 42d Street venture that it would seem to me that while we are looking for this so-called rifle shot that developers might consider reviewing what contributions they are making to improving the entire community because as attractive as 42d Street is and as we want it to be. It would seem to me that it would be at a disadvantage if tourists had to walk through inner city communities and find that we had this oasis there, but private investors had completely ignored other parts of this great island. So I would hope that as we talk about empowerment and enterprise zones that investors and developers at this site in mid-Manhattan might also consider what contributions you can make to make our city, but more specifically Manhattan Island more attractive.

If you have done anything along those lines, I would appreciate it being stated for the record.

Mr. MAYER. We certainly will review that with our principals, sir. I think we also should emphasize——

Chairman RANGEL. I have already reviewed it with your principals. I just hope that we can energize this amendment by showing that you cannot survive in a ghetto. You have to really see what the overall plans are and it would help those of us who live on the island to be more forceful in pushing this transition and extension.

Ms. CAHAN. Mr. Chairman, on behalf of my friends, the commercial developers of this project, I am the president of a not-for-profit organization which is responsible for six of the nine theaters on this block.

Chairman RANGEL. I used to play hooky and go to all of them.

Ms. CAHAN. So did lots of people, including me. We used to go to the movies on this street. I went to high school on 46th Street, and spent those 4 wonderful years close to 42d Street.

The developers, Times Square Center Associates, are making a $18.2 million contribution toward the renovation of two of the six theaters, under our jurisdiction so that those theaters will be transformed and reinvented as not-for-profit theaters. I think that is one part of their obligation to the City of New York, and all of our citizens, as well as all of those who visit our city. We are hoping to have the first of those theaters open in January 1995.

Chairman RANGEL. Thank you so much.

Ms. CAHAN. We have to thank the developers for that contribution.

Chairman RANGEL. Those are the types of things I was looking for. I thank you for your contribution. I yield back, Mr. Chairman.

Mr. PAYNE. Mr. Mayer, you mentioned that the change that is proposed would change this from an in-service day in 1998 to $250 million that would be invested at about this time. As a percentage of the cost of the entire project, how much is $250 million?

Mr. MAYER. Well, sir, the $250 million represents a portion of the land costs to date. We have funded the condemnation costs, we have funded certain city and State expenses, we have made contributions to the theaters. It is difficult to know what the ultimate cost of construction of our project will be, but it is estimated initially when we intended to build in the 1980s that the total cost would be $1 billion.

Mr. PAYNE. And that cost was estimated in 1986 because the tax act was——

Mr. MAYER. It was $1.2 billion for the four office towers in 1986 budgets plus land costs plus related public expenditures that we had to fund plus subway expenses that we were then required to fund.

Mr. PAYNE. And the $250 million as of this date is all in land costs?

Mr. MAYER. Land and somewhat related public expenses that we had to pay.

Mr. PAYNE. Subway improvements?

Mr. MAYER. Some subway improvements, some payments to the theater, some to the city and UDC's internal expenses, vast amounts of money to lawyers and architects.

Mr. PAYNE. Are there other projects that would be affected by the change of this transition rule or is this very specific?

Mr. MAYER. It only applies to the 42d Street project, all components of the 42d Street project.

Mr. PAYNE. Thank you very much. Mr. Hoagland.

Mr. HOAGLAND. Would your deadline be removed entirely? Mr. Mayer, as I read your proposal, that the deadline would be removed entirely if at least $250 million was incurred or committed before April 15 of this year?

Mr. MAYER. Yes, sir. Really the reason being that when the initial—the 1986 legislation was passed, we thought that the 1998 in-service requirement would easily be met, and we don't want to be mistaken again. That is why there is no stated outside date for the in-service rules.

Mr. HOAGLAND. Now, I assume the $250 million has been committed, right?

Mr. MAYER. It has been spent, sir.

Mr. HOAGLAND. And the original transition rule gave you 12 years?

Mr. MAYER. Yes, sir, the end of 1997.

Mr. WICKHAM. Congressman, we should also note that in the 1986 Act transition relief rules, there were a number of large-scale, long-term projects such as this where there were no placed in-service deadlines prescribed by the Congress. We have been through the 1986 Act, and I think there is some 69 projects where there were very large-scale projects, a number of them of rehabilitations of large areas of inner city areas such as we are dealing with here where—and that is still the case. There is no placed in service deadline because it is impossible at the time the Congress acts to really have a crystal ball how long it really will take for some of these large-scale projects to be completed.

I think that is the situation that has been experienced by the city, and the State, and the developers in this case.

Mr. HOAGLAND. So there is considerable precedent, in other words?

Mr. WICKHAM. Yes, there is. We can supply that in further detail if the subcommittee were interested. We have been through the statute, and we have counted 69 projects covered by transition relief rules in the, just the 1986 Act alone. There may be others for which there are no placed in-service deadlines because they are large-scale, long-term projects.

Mr. HOAGLAND. In these kind of projects do you consider revenue loss? Is that——

Mr. WICKHAM. Oh, yes.

Mr. HOAGLAND. Is there an estimate as to the revenue loss?

Mr. WICKHAM. Yes, there has been one prepared by Randall Weiss of the Deloitte & Touche, concluding that there is no revenue loss from enactment of this legislation during the period. I was advised yesterday that the—you may know better, but the staff of the Joint Committee on Taxation had similarly concluded that there is

no revenue effect from enactment of this during the period that the committee uses for budget and revenue-estimating purposes.

As a matter of fact, if there is any effect in this case, the slowdown in the project means that the time when the properties of the project will be placed in service will be later than was originally contemplated so that the value of the tax benefits preserved to the developer and the cost of according those to government will be decreased. That has been the essential effect of what has occurred in cases like this.

Mr. HOAGLAND. What is likely to happen to the project if the extension is not granted?

Mr. WICKHAM. I am sorry?

Mr. HOAGLAND. What is likely to happen to the project if this amendment is not adopted?

Mr. MAYER. Well, it is difficult to say with certainty, Congressman, but it becomes much more difficult for the project to continue. There is a substantial commitment of additional capital required beyond the $250 million to continue the project, and that in turn, the ability, willingness to commit those funds requires our being able to look out in the long term and see the project makes economic sense and is desirable for commercial tenants. These tax incentives make the project more leasable in the long term.

[The following was subsequently received:]

TIMES SQUARE CENTER ASSOCIATES

July 9, 1993

Honorable Charles A. Rangel
Chairman, Subcommittee on Select Revenue Measures
Committee on Ways and Means
U.S. House of Representatives
1105 Longworth House Office Building
Washington, D.C. 20519-6348

Dear Chairman:

I am writing to supplement and amplify my statements at the hearing on June 22, 1993 before your Subcommittee. I would appreciate having this amplification included in the record of the hearings if possible.

At the hearing, I appeared on behalf of Times Square Center Associates to support legislation which would preserve existing tax incentives for the continued development of the Times Square - 42nd Street Urban Renovation Project. As you know, these tax incentives presently apply only if the property is placed in service before January 1, 1998. The proposed legislation would remove the January 1, 1998 deadline if at least $250 million was incurred or committed for development of the Project before April 15, 1993.

1. Removal of deadline.

At the hearing, Congressman Hoagland noted that the legislative proposal would remove the placed-in-service deadline entirely. We believe that the removal of the deadline entirely, rather than a deferral of the deadline to another specific deadline, is justified by the large expenditures already incurred in reliance on the availability of the tax incentives and by the fact that failure to meet the existing deadline is due to factors beyond anyone's control or expectations. The $250 million already incurred in connection with the Project was invested in reliance on the tax incentives for construction of the office towers. Construction has been delayed by events beyond the control of the City, the UDC, and the developers, who are now in the process of amending the Project plan to defer construction of the office towers while proceeding with an interim retail low-rise development. This interim development will remain in place for an indeterminate period - until market conditions allow for the construction of new office buildings in Manhattan. Thus, although I cannot predict a definite date for completion of the

499 Park Avenue New York, NY 10022 212/355-7570
Telex 316526 PARKREALNYK

office towers, I can say that enactment now of a continuation of the tax incentives is vital to facilitate the long-term commitment of the substantial additional capital required, beyond the $250 million already expended, to continue development of the Project.

2. Cost of office towers.

At the hearing, Congressman Payne asked what percentage of the cost of the entire Project is represented by the $250 million investment. I responded that, in 1986, the estimated cost for the four office towers was $1.2 billion, plus land costs and related public expenditures. However, the most recent estimate of the cost of the four office towers has risen to $1.99 billion, exclusive of land costs and related public expenditures.

3. Contributions to improvement of New York City

At the hearings you asked for information for the record of the hearings about the contributions the developers of the Times Square - 42nd Street Project are making to improve the entire community, and to make New York City and especially Manhattan more attractive.

Times Square Center Associates, is a partnership consisting of an affiliate of Park Tower Realty Corp. and the Prudential Insurance Company of America, both of whom have a record of making major contributions to the improvement of New York City.

Substantial contributions to the improvement of the City are being made as part of the Times Square - 42nd Street Project itself. Thus, as was noted at the hearings by Cora Cahan, President of the not-for-profit organization, New 42nd Street, Inc., Times Square Center Associates has committed itself to making a contribution of $20 million toward restoration of the historic, off-Broadway theaters that are part of this project.

Our affiliate, Park Tower Realty Corp., has a long and continuing record of substantial contributions for the betterment of New York City, including our minority and disadvantaged communities. For example, an executive of an affiliate of Park Tower recently received an award in connection with efforts in hiring minority and local contractors in development of the Foley Square Project in lower Manhattan. Park Tower Realty also has provided advisory services in aid of the National Black Theaters development program. Park Tower's Chairman, Mr. George Klein, is an active member of the Board of the U.N. Development Corporation. As such, Mr. Klein has been instrumental in working

to keep UNICEF in New York City and in development of a hotel complex at the United Nations Plaza.

Park Tower's financial partner in the Times Square project, The Prudential Insurance Company of America, has established a strong reputation in New York as a major employer, a significant investor and a substantial contributor to the City's community programs, arts institutions and youth organizations. The Prudential payroll for its insurance, investment and securities operations numbers at least 9,000 in New York City alone, and an additiobnal 4,000 to 5,000 in Westchester County, Albany and other lcoations in New York State. In New York City and around the country, The Prudential has been a corporate leader committed to the restoration of urban neighborhoods through the National Community Development Initiative, a program that provides private funding for housing, day care and other facilities. The Prudential recently confirmed its corporate commitment to New York City in its decision to sign multi-year leases in dowtown Manhattan for the corporate headquarters, retail brokerage, asset management, and financial and administrative activities of its securities subsidiary, Prudential Securities.

I hope that this information is a useful supplement to my testimony.

Sincerely,

Matthew W. Mayer
for Park Tower Times Square
Associates, a partner

Mr. HOAGLAND. Mr. Chairman, may I address one question to Mr. Gregg? Mr. Gregg, what would the revenue effects be of your proposal of doing away with the notch proposal that you described?

Mr. GREGG. The entire revenue effect as it is estimated? There is a little background here. When it was put in H.R. 11 last year, they estimated that it was $50 million aggregate for a 5-year period. When a revenue estimate was prepared for when this occurred and somehow it has been accumulated to be $300 million, which we totally don't understand because under this amendment it is less generous than the one that was in the bill last year, so if anything, it should be less than $50 million, so I can't comment on how they came up with that estimate, but we can't concur with it.

Mr. HOAGLAND. Thank you, Mr. Chairman.

Mr. PAYNE. Thank you very much, Mr. Hoagland. Mr. Kopetski.

Mr. KOPETSKI. Thank you, Mr. Chairman. Mr. Gregg, could you just give us a comparison between a company situated as you are with this problem and the fixed base percentage compared to the typical fixed base percentage for some of your competitors which don't have the same problem under the R&D credit.

Mr. GREGG. Well, because we don't qualify as a startup company, because of the technical wording, we are limited at the cap 16 percent, which says we have to spend 16 percent of revenues, all of our industry. We spend very aggressively in R&D, and we are somewhere, depending on what period you want to look at, we are somewhere between 12 and 14 percent of revenue on a consistent basis. All of our competitors are in that 10—as low as 8, but as much as 14 percent of revenue, but because we are at the 16 percent cap we get no benefit from it.

Mr. KOPETSKI. In looking at who is working in these positions that do the R&D, are these highly skilled individuals?

Mr. GREGG. Extremely highly skilled. We have in Portland, Oreg., we have roughly 400 engineers working for Sequent, very highly skilled, largely software engineers but also hardware engineers. During the fixed base years, the 1984 through 1988 time frame, we averaged somewhere between $5 and $8 million of R&D per year. Currently this year we are budgeted to spend a little over $50 million in research and development, like I said, at about a 14 percent rate.

Mr. KOPETSKI. What is the average wage for one of these engineers?

Mr. GREGG. Oh gosh.

Mr. KOPETSKI. Or the range.

Mr. GREGG. All end costs somewhere between $50,000 and $70,000 per.

Mr. KOPETSKI. Is that a competitive field to attract the engineers?

Mr. GREGG. Extremely competitive. This is particularly in this developmental area of parallel processing computer systems, which is really, if you pick up Business Week or Fortune or any of the magazines in the last 3 weeks, the cover articles have been on the big technology payoff from microprocessor-based computer systems. So this is the way the industry is going, and we are very, very excited about the fact that we are one of the companies that is lead-

ing this whole U.S. computer industry into multiprocessor, parallel processing computers, so it is extremely competitive for the talent that we get particularly to attract them to Portland, Oreg.

Mr. KOPETSKI. So your competitors are spending less on R&D, and they get the credit, you are spending more?

Mr. GREGG. As a percentage of sales they are spending less, but obviously we are competing with some of the largest companies in the world, but as our financial results show, we have taken the company from $400,000 in 1984 to over $300 million in fiscal 1992. So we are doing quite well competing, but we are still relatively small compared to the big guys, but our percentage of R&D compared to sales is extremely high.

Mr. KOPETSKI. If you had this credit, would you put more money, resources into R&D?

Mr. GREGG. I would put as much as I could possibly put in there. My biggest restriction on how much R&D I can spend is because I am a public company and I have shareholders to answer to. I am trying to derive the 10 percent return after tax to those shareholders, and that is what they expect. And to the extent I am limited on R&D credit, it is going to come straight out of my R&D budget. That is the only place it can show up.

Mr. KOPETSKI. Thank you very much. I should point out, Mr. Chairman, that this company is not located in the 5th Congressional District of Oregon.

Mr. PAYNE. Thank you very much, Mr. Kopetski.

Are there any other questions of this panel? If not, I want to thank the panel and thank you very much for adhering to our 5-minute rule. We appreciate what you have said and presented to us today, and it is an important part of our legislative record. Thank you very much.

Mr. PAYNE. Our second panel, representing the John D. and Catherine T. MacArthur Foundation, James Griffin, vice president and general counsel; representing the Queen Emma Foundation, Ruth Ono, vice president, Queen's Health System; and representing the Emil Buehler Perpetual Trust, IRA Kaltman, tax counsel.

As the Chairman mentioned when we started this hearing, we would appreciate your confining your oral remarks to 5 minutes. Any statements you have will be put into the record in their entirety. Mr. Griffin, you may proceed as you wish.

STATEMENT OF JAMES GRIFFIN, VICE PRESIDENT AND GENERAL COUNSEL, JOHN D. AND CATHERINE T. MacARTHUR FOUNDATION, CHICAGO, ILL.

Mr. GRIFFIN. Thank you very much, sir. Mr. Chairman and members, I am James T. Griffin, vice president and general counsel of the John D. And Catherine T. MacArthur Foundation. The Foundation has submitted a written statement in support of its request for legislative relief, and I will stick strictly to a short summary.

We are located in Chicago, Ill., and with assets of approximately $2.9 billion, we expect to make charitable grants in excess of $160 million in 1993. The Foundation basically inherited, among other things, from the MacArthurs, over 53,000 acres of vacant real estate concentrated in North Palm Beach and south Martin Counties in Florida. There is other real estate, but some of it is improved.

The vacant real estate has caused a significant cash flow problem to the foundation, hindering the ability of the foundation to fund from current income its current charitable programs and thereby meet its required 5 percent minimum distribution requirement imposed on private foundations. The vacant real estate, which accounts for almost 30 percent of the assets of the foundation, does not produce any significant cash income and is really a cost to carry. The foundation's other investments do not produce sufficient cash income to overcome the absence of cash income from the vacant real estate in order to make our distribution requirements. We make them from other sources. In order for it to properly maintain its current charitable programs and preserve its assets over time, the foundation must generate cash income from the vacant real estate. The vacant real estate can only be sold presently at fire sale prices in today's real estate market, and for the foreseeable future sales can result in spending of the proceeds to make up the shortages or reinvestment in other assets to increase cash flow.

The best alternative is to develop the vacant real estate to produce cash income. The foundation will need cash to fund permitted development of the vacant real estate. The liquidation of the investment portfolio of stocks and bonds would clearly not be prudent, as it would cause the foundation to invest additional moneys into real estate in a concentrated geographical area. Further, such a liquidation would cause immediately and for the near term a reduction of cash income available to fund existing programs which could cause the foundation to cut back the funding of programs or spend ever more corpus.

The only real feasible alternative is to borrow the funds necessary to develop the real estate. If the foundation borrows the necessary funds, however, the income from such developed real estate will be subject to the debt-financed income provisions under section 514 of the Internal Revenue Code. Our rate would go from 2 percent to the presently around 34. The application of section 514 will cause the income derived from the developed real estate to be subject to that additional tax.

The additional income tax only thwarts the objective of the foundation, which is to generate additional cash income to fund existing charitable programs. We seek legislative relief from the application of the debt-financed income provisions. We do not seek any unique or unusual relief, but we request only the same exception to the debt-financed income rules currently available to retirement plans since 1980 and universities since 1984 under code section 514(c)(9). Under such section universities' retirement plans are not subject to the debt-financed income provisions for real estate investments. We seek only that same exemption available to them. It is sought due to the unusual circumstances in which the foundation finds itself by inheritance with a substantial portion of its portfolio in inherited vacant real estate which is not providing any significant current income. Thank you very much.

Mr. PAYNE. Thank you very much, Mr. Griffin.

[The prepared statement follows:]

JOHN D. AND CATHERINE T. MACARTHUR FOUNDATION

LIMITED EXTENSION OF SECTION 514(c)(9)
OF THE INTERNAL REVENUE CODE TO INCLUDE CERTAIN
FOUNDATIONS WITH INHERITED REAL ESTATE

Legislative Background

The section 514 "debt-financed" income provisions were added to the Internal Revenue Code by the Tax Reform Act of 1969 in response to the Clay Brown, University Hill Foundation, and other cases. The problem to which section 514 was directed involved leveraged acquisitions of assets by tax-exempt organizations. Typically, the exempt organization would purchase a corporate business, agreeing to pay the purchase price out of profits generated from the purchased assets. It would then liquidate the business and lease its assets back to the original seller. Rents would be used to make debt payments. The seller/lessee could deduct the rents in calculating its ordinary income, and receive them back in the form of debt satisfaction on the original sale, with the gain portion of each installment taxable at lower capital gains rates. Eventually, the debt would be repaid and the exempt organization would own the assets, free of debt, at little or no out-of-pocket cost.

In 1980, Congress amended the debt-financed income rules by adopting an exception for leveraged real estate investments by qualified pension trusts, coupled with various restrictions to prevent abuses. This exception, section 514(c)(9), was extended to educational institutions described in section 170(b)(1)(A)(ii) and their supporting organizations in 1984, along with additional restrictions applicable to pension trusts, educational institutions, and their supporting organizations.

History

In 1978, the John D. and Catherine T. MacArthur Foundation received all of the stock of Bankers Life and Casualty Company ("Company") from a trust created by John D. MacArthur during his lifetime. As part of an overall plan to comply with the divestiture requirements of the excess business holding rules under Sections 4943 of the Internal Revenue Code, various real estate assets located throughout the United States with an aggregate value in excess of $1.4 billion were distributed by the Company to the Foundation in December of 1983 pursuant to a plan of partial liquidation approved by the IRS.

The real estate assets consisted of extensive holdings in New York (including in excess of 10,000 apartment units, and 19 commercial and office buildings) and Florida. The Florida real estate assets included approximately 98,000 acres of vacant real estate in Southern Florida, and in particular, approximately 53,000 acres of vacant real estate in northeast Palm Beach and southeast Martin Counties. Following the 1983 distribution of real estate, approximately 86% of the Foundation's assets were invested in real estate, all of which was essentially inherited from John D. MacArthur.

Since 1983, the Foundation has disposed of the Company, and its sales of inherited real estate assets have exceeded $1.0 billion. Proceeds from these sales were invested in income-producing financial assets, such as stocks and bonds. See Exhibit 1, which shows the Foundation's total asset allocations for the years 1983 through 1992.

Despite its continuing effort to reduce its real estate holdings, the Foundation continues to own 43,400 acres of unimproved real estate in Florida, concentrated in Palm Beach and Martin Counties. See Exhibit 2 which contains a map showing the location of the real estate. The Foundation has been advised by independent consultants to continue to take aggressive steps to reduce its remaining real estate holdings, and in particular, to significantly reduce the

concentration of its vacant real estate holdings in Florida, but to do so in an orderly way so as to realize the full value of the assets and avoid adversely affecting the values of other properties in the surrounding areas.

Although the Foundation has made efforts to sell the Florida real estate, the economy in recent years, along with the regulatory environment, including an extensive comprehensive land use plan adopted by the State of Florida, has discouraged development and resulted in minimal sales. Moreover, the Foundation has been forced to take back, or participate in "work-out" arrangements for, several properties it sold because of problems experienced by buyers. As a result of all of these factors, the Foundation's real estate assets, in particular the Florida real estate, suffered a reduction in market value of over $300 million based on a 1992 reappraisal of such real estate.

Notwithstanding the decrease in value of its real estate assets, the Foundation has continued to increase its charitable giving. Grants totalling $749.8 million were made during the past five years, far in excess of the 5% minimum distribution requirement applicable to private foundations (see Exhibit 3, which shows the Foundation's actual charitable distributions and the minimum distribution requirements for the years 1984 through 1992).

Problem

The John D. and Catherine T. MacArthur Foundation finds that the income from its investment portfolio is not sufficient to maintain its existing charitable programs, because nearly 28 % of its assets remain invested in real estate that does not generate significant cash income to fund the charitable programs. The non-real estate portion of the Foundation's investment portfolio alone does not generate sufficient income to continue to fund and maintain the desired level and quality of the Foundation's charitable programs. Without additional income from the real estate holdings, the Foundation will have no alternative but to curtail its charitable programs.

The current income yield from the real estate is low because most of the properties are vacant. Selling the real estate is not feasible, due in particular to the limited marketability of the unimproved land and the present state of the economy. Further, the Florida real estate is subject to economic pressures, as well as a regulatory environment that discourages economic development by third-party developers. The economy in which the real estate is situated is stagnant, and it does not appear that revival is imminent. The Foundation needs to find ways to make the vacant Florida real estate either more productive or more saleable in today's market.

Real estate development activities are a necessary element in order to generate current income and create economic demand for the Florida real estate, which over the long term will generate sufficient revenues to fund its share of the Foundation's charitable programs. Absent such activity, the only alternative that the Foundation will have will be to reduce the level of its charitable programs, which would be to the disadvantage of various charitable organizations located all over the world, and their ultimate beneficiaries. See Exhibits 4 and 5, which show projections of future net income, approved charitable distributions, and cumulative asset sales that will be required if additional revenue is not forthcoming.

The Foundation finds that it has no reasonable alternative for funding the development of the vacant Florida real estate other than to borrow funds. The principal alternative--liquidation of a significant portion of its current investment portfolio of stocks and bonds to fund the improvements--would be imprudent, irresponsible, and unreasonable. Such a liquidation would cause an

immediate reduction in income available to fund the Foundation's existing charitable programs and commitments, and cause further concentration of the Foundation's assets in Florida real estate. The current and potential beneficiaries of the Foundation's programs would suffer immediately from the loss of funds to meet current obligations and face the risk of future losses associated with concentrating an even greater portion of the Foundation's endowment in real estate. In contrast, the use of debt to fund improvements to real estate is a traditional and accepted method of financing in the real estate sector and would allow the Foundation to maximize the productivity of its assets for the benefit of charity, both now and in the future.

The use of debt to fund the economic development of the Florida real estate, however, would cause the income generated from the property to be characterized under current law as "debt-financed" and to be taxable as unrelated business taxable income.

The income tax payable due to the application of the debt-financed income rules would make the additional investment to develop the Florida real estate uneconomical compared to other investments. Moreover, and most importantly, the taxes would further reduce the funds available to maintain and enhance the Foundation's charitable programs. Thus, under present law, the Foundation and the public loses regardless of whether the Foundation borrows to fund the development of its real estate or liquidates a portion of its portfolio of stocks and bonds.

Proposal

The special exception from the debt-financed income rules of section 514(c)(9) currently applicable to pension trusts and educational institutions would apply to debt incurred by a private foundation (as defined in section 509(a)) to improve any real property if--

(1) at any time, since it was organized, more than half of the assets, determined by value, held by the foundation and acquired, directly or indirectly, by gift or devise, consisted of improved and unimproved real property,

(2) immediately prior to the time the debt was originally incurred, real estate acquired, directly or indirectly, by gift or devise, exceeded 10% of the value of all investment assets held by the Foundation, and

(3) no member of the organization's governing body was a disqualified person (as defined in section 4946) during the period the debt remains unpaid other than by virtue of being a "foundation manager."

To prevent any unintended abuses, the proposed changes would be subject to the same anti-abuse limitations that apply today to pension trusts and educational organizations.

Rationale

Where a private foundation has received by gift or devise non-charitable assets in the form of real estate that produces little or no current income, the foundation must choose among these options: (1) reduce its charitable program, (2) sell income-producing assets, (3) sell its unimproved real estate at "fire sale" prices in today's market and for the foreseeable future, or (4) improve the real estate to make it income-producing. In order to improve its real estate, the foundation will have to borrow. However, the penalties imposed by the debt-financed income rules will make an otherwise attractive investment unattractive.

As was true for pension trusts and educational institutions before the current law exception was adopted, the debt-financed income

rules make many otherwise economically sound investments non-economic. The adverse impact of the tax is exacerbated by the following: (1) in a perverse fashion, as time passes, the portion of overall income that is made taxable increases even where the amount of debt is constant or falling; and (2) most, if not all, gain upon disposition is subjected to taxation if the property is sold while the acquisition indebtedness continues to be outstanding.

Finally, the proposed change would supplement the Administration's current attempts to restore vitality to the real estate sector. The Foundation's efforts to improve the productivity and marketability of its own real estate should be expected to enhance the economy of the surrounding community and produce ripple effects that benefit everyone as a result of the desired economic stimulation.

Board of Directors

No member of the Board of Directors is in any way related to John D. or Catherine T. MacArthur, founders of the Foundation. (See Exhibit 6 which contains a listing of the present members of the Board of Directors of the Foundation.)

Conclusion

The Foundation seeks the same legislative relief currently available to retirement plans and educational institutions. There is no valid basis for according such relief to such other organizations and not to the Foundation or other similarly situated charitable organizations.

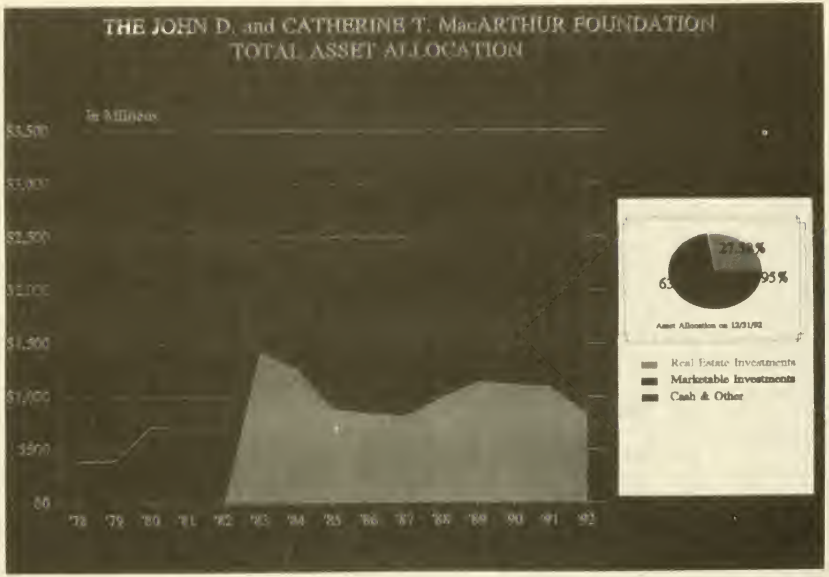
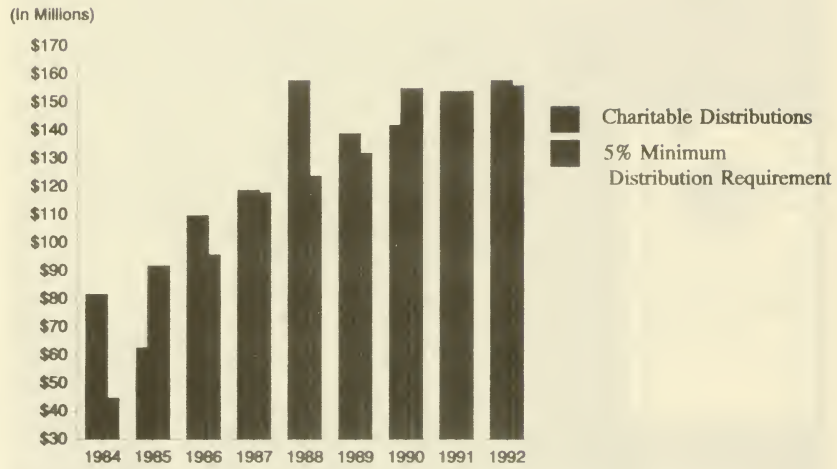

THE JOHN D. and CATHERINE T. MacARTHUR FOUNDATION
TOTAL ASSET ALLOCATION
In Millions
$3,500
$2,500
$1,500
$500
'78 '79 '80 '81 '82 '83 '84 '85 '86 '87 '88 '89 '90 '91 '92
27.3%
95%
Asset Allocation on 12/31/92
Real Estate Investments
Marketable Investments
Cash & Other

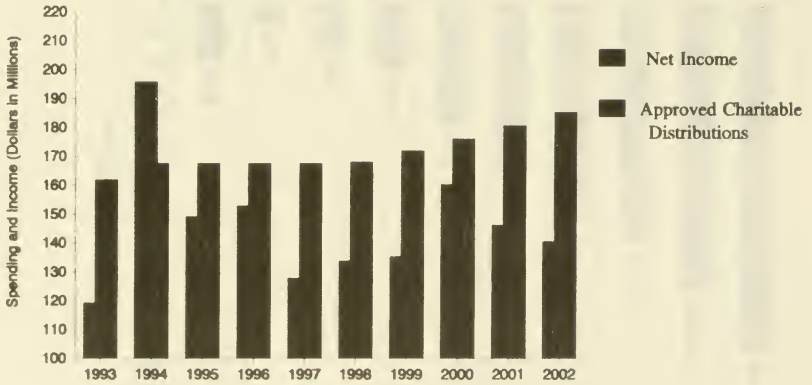
EXHIBIT 1

HOLDINGS
FOUNDATION HOLDINGS
SCALE
DATE: APRIL, 1993

The John D. and Catherine T. MacArthur Foundation
Analysis of Distribution



THE JOHN D. and CATHERINE T. MacARTHUR FOUNDATION
APPROVED CHARITABLE DISTRIBUTIONS vs. NET INCOME



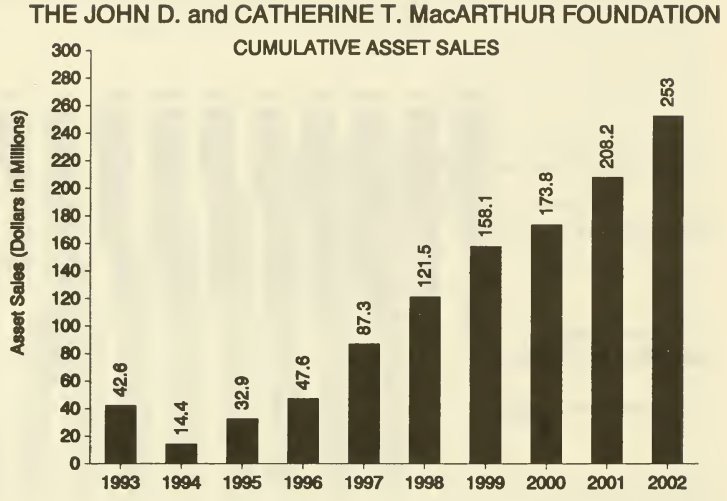

THE JOHN D. and CATHERINE T. MacARTHUR FOUNDATION
CUMULATIVE ASSET SALES
Asset Sales (Dollars in Millions)
300
280
260
240
220
200
180
160
140
120
100
80
60
40
20
0
42.6
14.4
32.9
47.6
87.3
121.5
158.1
173.8
208.2
253
1993
1994
1995
1996
1997
1998
1999
2000
2001
2002

EXHIBIT 5

John D. and Catherine T. MacArthur Foundation

Board of Directors

John E. Corbally, Former President of the University of Illinois

Robert P. Ewing, Retired Chairman of Bankers Life and Casualty Company

William H. Foege, M.D., Executive Director of the Carter Center of Emory University

James M. Furman, Retired Executive Vice President of the Foundation

Murray Gell-Mann, Millikan Professor of Theoretical Physics, California Institute of Technology, Nobel Laureate

Alan M. Hallene, President, Montgomery Elevator International

Paul Harvey, News Commentator, American Broadcasting Company

John P. Holdren, Professor of Energy and Resources, University of California, Berkeley

Shirley Mount Hufstedler, Attorney-at-Law

Sara Lawrence Lightfoot, Professor of Education, Harvard Graduate School of Education

Margaret E. Mahoney, President, The Commonwealth Fund

Elizabeth J. McCormack, Associate, Rockefeller Family & Associates

George A. Ranney, Jr., Attorney-at-Law

Jonas Salk, M.D., Founding Director and Distinguished Professor in International Health Sciences, The Salk Institute for Biological Studies, Developer of the polio vaccine which bears his name

Adele Simmons, President of the Foundation

Jerome B. Wiesner, President Emeritus and Institute Professor, Massachusetts Institute of Technology.

EXHIBIT 6

Mr. PAYNE. Dr. Ono.

STATEMENT OF RUTH M. ONO, PH.D., VICE PRESIDENT, QUEEN'S HEALTH SYSTEM ON BEHALF OF QUEEN EMMA FOUNDATION, HONOLULU, HAWAII

Ms. ONO. Thank you. Mr. Chairman and distinguished members of the subcommittee, good afternoon and Aloha. My name is Ruth Ono. I am a vice president of the Queen's Health Systems of Honolulu, Hawaii, a major provider of health care services to the people of the State of Hawaii. I am pleased to be here today representing the Queen Emma Foundation, a member of the Queen's Health Systems. With me today is Mike Walsh, vice president and treasurer of the Queen Emma Foundation.

You are considering a proposal to treat private foundations like educational organizations and pension funds for purposes of the unrelated business income rules governing debt-financed property. We respectfully request your favorable consideration in extending this treatment to organizations like the Queen Emma Foundation.

The Queen Emma Foundation is a nonprofit, tax-exempt public charity. Its purpose is to support and improve health care services in Hawaii by committing funds generated by foundation-owned properties to the Queen's Medical Center, Hawaii's major teaching hospital and a major part of the Queen's Health Systems. The hospital serves 19,000 inpatients plus 172,000 outpatient visits and 27,000 emergency room visits each year.

Since there are no State, county or municipal acute care hospitals on Oahu, Queens, although not a public hospital, is in fact perceived as such by the people of Oahu. We serve the public at large, including the Medicare and Medicaid population. As you know, the State of Hawaii is a group of islands separated by water. Necessarily Queen's has taken over the responsibility for the only hospital on the Island of Molokai, which had been crippled with financial problems that threatened its closure. Queen's also operates clinics on the neighbor islands, provides home health care services, supports nursing programs at the University of Hawaii and community colleges, and operates a medical library.

In other words, Queen's has served the people of our State with a sense of Aloha, unique to Hawaii. The foundation's assets consist largely of land bequeathed in 1885 by our founder, Queen Emma Kaleleonalani. Most of the foundation's land is encumbered by long-term, fixed rent, commercial and industrial ground leases. The return produced by these leases is extremely low, as the foundation is unable, under these leases, to increase rents to keep pace with the rapid appreciation in land values in Hawaii. This severely limits the foundation's ability to provide funding to the medical center.

The foundation could increase the funds available to support the medical center's health care endeavors by buying out the leases of current lessees and leasing the land, together with any buildings on the land at current market rates. The foundation also could upgrade the improvements on its land to further enhance its revenue-generating potential. However, doing this on a scale that would appreciably increase the funds available to support the medical center would require more cash than the foundation has available or could prudently generate by selling assets.

The best solution to this problem would be for the foundation to borrow the necessary funds. However, any income earned by the foundation would be taxed, according to the debt-financed property rules under the unrelated business income tax, greatly reducing the funds ultimately available to meet its charitable mission.

The foundation therefore proposes that the exception to the debt-financed property rules that currently applies to educational organizations and pension funds be expanded to cover organizations like the Queen Emma Foundation. In particular, the foundation proposes that the exception be expanded to cover organizations that are supporting organizations to hospitals that hold significant assets in the form of bequeathed real property and that are governed by boards of directors that are broadly representative of the public.

Current law safeguards would apply under our proposal. Such a proposal, if enacted, would enable the foundation to generate more funds to support the medical center in pursuit of its charitable mission and provide better health care to the people of Hawaii.

Mr. Chairman and members of the subcommittee, thank you for the opportunity to testify. Our written statement has been submitted for the record. We shall be pleased to answer any questions.

Mr. PAYNE. Thank you very much, Dr. Ono.

[The prepared statement follows:]

STATEMENT OF RUTH M. ONO, PH.D.
BEFORE THE SUBCOMMITTEE ON SELECT REVENUE MEASURES
OF THE HOUSE COMMITTEE ON WAYS AND MEANS

JUNE 22, 1993

Mr. Chairman and Distinguished Members of the Subcommittee:

Good morning. My name is Ruth Ono. I am a Vice-President of the Queen's Health Systems (the "Queen's) of Honolulu, Hawaii, a major provider of health care services to the people of the State of Hawaii. I am pleased to be here today representing the Queen Emma Foundation (the "Foundation"), a member of The Queen's Health Systems. With me is Michael Walsh, who is Vice-President and Treasurer of the Queen Emma Foundation.

The Foundation commends the Subcommittee for considering a proposal to treat private foundations like educational organizations and pension funds for purposes of the unrelated business income rules governing debt-financed property. We ask that the Subcommittee also consider extending this treatment to organizations like the Queen Emma Foundation.

BACKGROUND

The Queen Emma Foundation is a nonprofit, tax-exempt, public charity. Its purpose is to support and improve health care services in Hawaii by committing funds generated by Foundation-owned properties to The Queen's Medical Center (the "Medical Center").

The Queen's Medical Center

The Queen's Medical Center began operations in 1860 as a two-story, 124-bed hospital located in Honolulu. The Medical Center has grown to become a 536-bed accredited teaching hospital, accomodating nearly 19,000 inpatient admissions and 172,000 outpatient visits per year. The Medical Center maintains an open emergency room, and admits Medicare and Medicaid patients. It has more than 1,200 physicians on staff, and over 2,800 full-time employees.

The Queen's Health Systems, through the Medical Center, the Foundation, and its other members, provides health care services that benefit residents of all of the Hawaiian Islands. For example, the Queen's operates Molokai General Hospital, a small community hospital on the remote island of Molokai. The Queen's also operates clinics on various islands, provides home health care services, supports nursing programs at Hawaiian colleges and universities, operates a medical library, and holds health fairs and other educational events for the benefit of the community.

The Queen Emma Foundation

The Foundation's assets consist largely of land bequeathed in 1885 by Queen Emma Kaleleonalani, wife of King Kamehameha IV. Most of the Foundation's land is encumbered by long-term, fixed-rent commercial and industrial ground leases. The return produced by these leases is extremely low, as the Foundation is unable, under these leases, to increase rents to keep pace with the rapid appreciation in land values in Hawaii. This severely limits the Foundation's ability to provide funding to the Medical Center.

The Foundation could increase the funds available to support the Medical Center's health care endeavors by buying out the leases of current lessees, and leasing the land, together with any buildings on the land, at current market rates. The Foundation also could upgrade the improvements on its land to further enhance its revenue-generating potential. However, doing this on a scale that would appreciably increase the funds available to support the Medical Center would require more cash than the Foundation has available or could prudently generate by selling assets.

The best solution to this problem would be for the Foundation to borrow the necessary funds. Were the Foundation to do this, however, the debt-financed property rules under the unrelated business income tax would subject the income earned by the Foundation to income tax, greatly reducing the funds ultimately available to meet its charitable mission.

OVERVIEW OF THE DEBT-FINANCED INCOME RULES

Unrelated Business Income Tax

The unrelated business income tax ("UBIT") applies, under sections 511 through 514 of the Internal Revenue Code[1], to certain otherwise tax-exempt organizations. The UBIT generally imposes a tax on the net income earned by a tax-exempt organization from trade or business activities that are "regularly carried on" and that are not "substantially related" to the organization's exempt purpose.

In enacting the UBIT, Congress specifically excluded from tax certain types of investment income. Congress did this because, in its view, such income is "passive in character", "not likely to result in serious competition for taxable businesses", and has "long been recognized as a proper source of revenue for educational and charitable organizations and trusts."[2]

One of the categories of passive investment income normally not subject to UBIT is rents from real property. Gains from the disposition of property is another category of income normally not subject to UBIT. The exclusion for gains from the disposition of property does not apply if the property is inventory or held primarily for sale to customers in the ordinary course of the trade or business.

Debt-Financed Income

Congress was concerned, when it enacted the UBIT, with sale-leaseback transactions involving tax-exempt organizations. Congress was particularly concerned with transactions where tax-exempt organizations purchased properties for little or no money down and leased them back to the sellers. Under this scenario, the tax-exempt organization could "trade" on its tax exemption by paying an inflated price for the asset or charging a below-market rent. The tax-exempt organization could do this, while still meeting its installment obligations, because it did not have to pay taxes.

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[1]All section references hereafter are to the Internal Revenue Code of 1986.

[2]Senate Report No. 2375, 1950-2 C.B. 483.

To counter this perceived abuse, the 1950 UBIT contained special rules which subjected to tax certain otherwise excludible passive income derived from debt-financed property. These rules were modified in 1969 in response to what Congress saw as continued problems in the area, particularly with so-called "Clay Brown" or "bootstrap" transactions. In this variation on a sale-leaseback transaction, the tax-exempt organization would pay the purchase price as a percentage of the rental income it earned from leasing the property back to the seller.

The rules enacted in 1969 are codified in section 514. Under section 514, for most types of tax-exempt organizations, the rules exempting from UBIT rents and gains from sale do not apply to the extent such rents and gains are derived from debt-financed property.

Qualified Organizations

Congress amended the debt-financed income rules in 1980 by enacting section 514(c)(9). Section 514(c)(9), as originally enacted, provided an exception to the debt-financed income rules for certain real estate investments of qualified pension trusts, subject to various restrictions intended to prevent abuses.

In enacting this provision, the Senate Finance Committee stated that it felt that it was "inappropriate to continue the present law restrictions on debt-financed income to the extent that they discourage prudent debt-financed real estate investments", noting that "debt-financing is common in real estate investments", and that "specifically drawn prohibitions of debt-financed acquisitions with certain characteristics can eliminate the most egregious abuses addressed by the 1969 legislation . . ."[3]

In 1984, section 514(c)(9) was extended to cover educational institutions, such as colleges and universities, and their supporting organizations. Additional requirements were also added to prevent the abuses that existed prior to 1969. In so doing, the Senate Finance Committee stated that:

> The committee believes that it is appropriate to extend the special exception for debt-financed property held by a qualified trust to similar property held by an educational organization . . . However, the committee feels that this exemption should be extended only if certain of the present law requirements are expanded.[4]

PROPOSAL

The Foundation proposes that the exception to the debt-financed property rules that currently applies to educational organizations and pension funds be expanded to cover organizations like the Queen Emma Foundation that (1) are supporting organizations to hospitals, (2) hold significant assets in the form of bequeathed real property, and (3) are governed by boards of directors that are broadly

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[3]Senate Report 96-1036, 1980-2 C.B. 723.

[4]Committee on Finance, United States Senate, Deficit Reduction Act of 1984, Explanation of Provisions Approved by the Committee on March 21, 1984 (S. Prt. 98-169, Vol. I, April 2, 1984).

representative of the public.

In particular, the Foundation proposes that section 514(c)(9) be amended by adding a new class of "qualified hospital support organizations" eligible for the section 514(c)(9) exception to the debt-financed property rules. A qualified hospital support organization would be defined as an organization recognized as tax-exempt under section 501(c)(3) and as a supporting organization (under section 509(a)(3)) to a hospital (as defined in section 170(b)(1)(A)(iii)).

A qualified hospital support organization would also need to meet the following requirements to qualify for the exception under section 514(c)(9):

1. at any time, since it was organized, more than half of the assets, determined by fair market value, held by the organization and acquired, directly or indirectly, by gift or devise, consisted of real property,

2. at the time the debt was originally incurred, real property, acquired, directly or indirectly, by gift or devise, including improvements, exceeded 10 percent of the fair market value of all investment assets held by the organizations, and

3. no member of the organization's governing body was a disqualified person (as defined in section 4946) at any time during the taxable year in which the debt was originally incurred, other than by virtue of being a "foundation manager".

Special rules would apply to refinancings of debt.

CONCLUSION

This proposal, if enacted, would enable the Foundation to generate more funds to support the Medical Center in pursuit of its charitable mission, and provide better health care to the people of Hawaii.

Mr. Chairman, Members of the Subcommittee, I thank you for taking the time to hear my testimony. I urge you to consider our proposal and the positive effect it would have on the health and well-being of the people of Hawaii.

I would be pleased to answer any questions you may have.

Mr. PAYNE. Mr. Kaltman.

STATEMENT OF IRA J. KALTMAN, TAX COUNSEL, ON BEHALF OF EMIL BUEHLER PERPETUAL TRUST, PARAMUS, N.J.

Mr. KALTMAN. Mr. Chairman, distinguished members, staff and guests, I am Ira Kaltman, a member of the firm of Hartman Buhrman & Winniki. I am tax counsel to the Emil Buehler Perpetual Trust. The John D. and Catherine T. MacArthur Foundation has presented the problem imposed by the debt-financed income rules of section 514 upon a foundation that has significant holdings of unimproved real estate. The onerous burden that section 514 imposes upon private foundations also comes into play if a foundation seeks to rehabilitate improved real estate which it has acquired by gift or devise.

It is this latter situation in which the Emil Buehler Trust finds itself and to which I will address my remarks.

The Emil Buehler Trust was established in 1984 pursuant to the terms of the late Emil Buehler's will to preserve his commitment to aviation science and technology. Mr. Buehler was an aviation visionary and engineer who had an overwhelming interest in educating the public about all facets of aviation. In recent years, the trust has made many grants to colleges and universities for numerous projects related to aviation. These projects have included, among other things, the installation and upgrading of wind tunnels, flight simulators, and a planetarium at various colleges and universities throughout the United States.

The trust also provides funds for scholarships and internships at various institutions. In addition, the trust has funded the restoration of various aircraft through another private operating foundation, Buehler Aviation Research, and one such aircraft was installed recently in the Smithsonian Institutions, the Grumman goose.

Mr. Buehler, in addition to being a successful architect and engineer was an early entrepreneur in the field of land development and consequently developed several parcels of land in northern New Jersey in the late 1950s. Upon his death these parcels of real estate became the principal assets of the trust.

The current value of all trust assets is approximately $30 million. Sixty-six percent of the assets after depreciation consist of real estate. Less than 1 percent of the trust's assets are in unimproved real estate.

Unfortunately, the trust's improved real estate consists of office buildings which are more than 40 years old and require constant repair and maintenance. All of the real estate is locate in an area that has felt the brunt of the current recession which has resulted in declining real estate values and high office vacancy rates. Moreover, the character of the area has changed since the 1950s from mixed commercial use to almost exclusive retail use. Accordingly, the trust is in the process of redeveloping its real estate to adopt to the current changed environment.

The trust buildings may be viewed as dinosaurs in a market area which in the last 10 years has seen the development of sleek, modern office complexes. Currently, the trust's buildings have a 60 per-

cent vacancy rate and the prospects for the future of these buildings is far from promising.

The depressed state of the real estate market has left the trust in a difficult position. In order to continue to make grants to worthy organizations, it must seek to improve and maximize its portfolio holdings. However, it is both impractical and imprudent for the trust to direct the sale of these aged buildings in a declining market. On the other hand, the trust is having an extremely difficult time attracting new tenants. In order to rehabilitate or raise and reconstruct these buildings, the trust must either borrow funds or liquidate properties. If the trust does borrow funds, it will fall directly into the trap of the debt finance income rules of section 514. This problem has recently impacted the trust directly when it financed the construction of a retail center on the site of one of its former office buildings. The taxes that must be paid under section 514 as a result of this financing amounts to approximately $105,000 for the first year the debt is outstanding and will continue at a similar level for 5 years. It should be emphasized that the amounts expended on the unrelated business income tax as a result of the debt-financed income rules could better be utilized to fund grants to worthy recipients, especially in this era of fiscal austerity when the private sector is called upon to bear the ever increasing burden of charitable programs.

It is respectfully submitted that private foundations that have received substantial gifts or devises of less than marketable real estate should not be hampered in their desire to maximize the value of their assets. These private foundations should not be faced with the Hobson's choice of liquidating certain parcels of real estate to improve the value of others or borrow funds and be subject to the toll charge imposed by section 514.

Thank you. I will be happy to answer any questions.

Mr. PAYNE. Thank you very much, Mr. Kaltman.

[The prepared statement follows:]

LIMITED EXTENSION OF SECTION 514(c)(9) EXCEPTION

STATEMENT OF THE EMIL BUEHLER PERPETUAL TRUST

History

The Emil Buehler Trust was established in 1984 pursuant to the terms of the late Emil Buehler's Will to preserve his commitment to aviation science and technology. Mr. Buehler was an aviation visionary, architect and engineer. Mr. Buehler's interest in aviation science and technology was the motivating force behind the establishment of The Emil Buehler Trust, which is dedicated to aviation research and education.

In addition to being a successful architect and engineer, Mr. Buehler was an entrepreneur in the field of land development and developed several parcels of property in northern New Jersey in the late 1950's. Upon Mr. Buehler's death, these parcels of real estate became the principal assets of the Trust.

At the present time, the value of all Trust assets is in excess of $30,000,000. Sixty-six percent of the assets of the Trust (after depreciation) consist of real estate. Less than one percent of The Emil Buehler Trust's assets are in unimproved real estate.

The improved real estate which is owned by the Trust consists of office buildings which are more than 40 years old, and require constant repair and maintenance. All of the rental real estate is located in northern New Jersey, an area which has seen declining real estate values in recent years, and high office vacancy rates. There are many buildings in the area owned by private developers which were built in the 1980's that are actively seeking tenants. The high vacancy rate for commercial properties in the area is a testimony to the depressed state of the market.

The depressed real estate market leaves the Trust in a difficult position. In order to continue to make grants to worthy organizations, it must try to improve and maximize its portfolio holdings. However, it would be impractical to sell aged buildings in a declining market; while, on the other hand, the Trust finds that it is increasingly difficult to secure new tenants in a real estate market where most of the buildings have been built within the last ten years. In order to enhance the value of its properties and make them more marketable and income-producing, the Trust will eventually have to make major modifications to its existing buildings, if not replace them altogether.

The Trust would have no reasonable alternative for funding the construction and reconstruction of its various properties, other than to borrow funds. The alternative of liquidating properties in order to improve other parcels of real estate in light of current market conditions is not feasible.

The Problem

The use of debt to fund the development of the Trust's northern New Jersey properties would cause the income generated from the properties to be characterized as "debt financed" and be taxable as unrelated business taxable income under Section 514 of the Internal Revenue Code. The additional tax paid by the Trust as a result of its efforts to improve the real estate would further reduce the funds available to maintain and enhance its charitable functions. Accordingly, the Trust agrees with the representatives of the John D. and Catherine T. MacArthur Foundation that Section 514 in its present form requires both the public and the private foundation to lose because development projects must be funded either by debt-financing or liquidation of a portion of the portfolio assets of a trust or foundation.

The Emil Buehler Trust joins in the application of the John D. and Catherine T. MacArthur Foundation in requesting a change in Section 514(c)(9) to alleviate the foregoing problems.

Proposal

The Trust believes that the public interest would best be served if the special exception from the debt-financed income rules of Section 514(c)(9) relating to so-called "qualified organizations" would be extended to private foundations if:

(1) at any time, since it was organized, more than half of the assets, determined by value, held by the foundation and acquired, directly or indirectly, by gift or devise, consisted of improved and unimproved real property, and

(2) at the time the debt was originally incurred, real estate acquired, directly or indirectly, by gift or devise, exceeded 10% of the value of all investment assets held by the foundation, and

(3) no member of the organization's governing body was a disqualified person (as defined in Section 4946) at any time during the taxable year, other than by virtue of being a "foundation manager".

Rationale

Other "qualified organizations", such as pension trusts and educational institutions currently enjoy the ability to enhance the value of their real estate portfolios because they are free from the debt-financed income rules. It is respectfully submitted that the foundations which have significant portfolios of either improved or unimproved real estate should enjoy the same benefits. In addition to allowing private foundations to enhance the value of their portfolios, and thus, their ability to increase their grant payouts, this legislative change would stimulate the real estate sector in general.

Conclusion

The Emil Buehler Trust joins with the John D. and Catherine T. MacArthur Foundation in seeking a change to the debt-financed income rules of Section 514. There are no grounds for reducing the amount of funds that are available from such organizations, or similarly situated charitable organizations, for charitable purposes merely because the principal assets of such organizations consist of real estate rather than marketable securities.

Mr. PAYNE. Mr. Chairman.

Chairman RANGEL. Ms. Ono, at this hospital, which is attributed to the queen, do they take uninsured patients?

Ms. ONO. Yes, we certainly do.

Chairman RANGEL. And let me congratulate the MacArthur Foundation for the fine work that you do throughout the country.

Mr. GRIFFIN. Thank you very much, Mr. Chairman. We are very proud of it.

Chairman RANGEL. We all are. If I understand your proposal, it is that you want to borrow money to develop undeveloped property and then rent it and have it considered as a business related to the charity.

Mr. GRIFFIN. Technically that is correct. We want to avoid the higher tax rate, that is correct.

Chairman RANGEL. Well, you know that the Congress is under a lot of pressure in terms of trying to keep the charities to doing charity work as opposed to appearing as though it is getting involved in other type businesses. What type of property development are you talking about? What do you intend to do, office buildings, residential buildings?

Mr. GRIFFIN. Well, the market down there probably wouldn't be very good for office buildings or for industrial right now, but they could be apartment buildings. This so-called business is really just part of our investment arm. It is not a separate business that we are really going into.

Chairman RANGEL. Well, I guess most of the problems on this issue for the committee is with people who do pay taxes that are doing the same kind of business that you would be seeking to do and avoiding taxes, and, even though, I note, that the income would be used for charitable purposes. But I guess what I am asking you is that how would I explain to a developer across the street from your undeveloped property why you would be able to charge less rents and build apartment buildings a lot cheaper than he because of your tax advantage?

Mr. GRIFFIN. Well, I don't know that we actually would build it any cheaper than he and I don't know that we actually would charge any lower rents than he. We might have additional funds to give away to our charities who very frequently convert those to taxable funds by their distributions rather promptly, but we are in head-to-head competition, if you will, with some real estate people in the State of Florida, but you don't find any disparate market differentials between ourselves and them in the main. It just doesn't seem to happen that way in the real estate area.

Chairman RANGEL. Is it safe to say, then, Mr. Griffin, that if the Congress approved your exception to the rules that we would not hear any complaints from any developers in the areas in which you intend to develop?

Mr. GRIFFIN. Well, it is pretty difficult to predict, almost as difficult as the market.

Chairman RANGEL. I am just saying that based on your experience that you have not really seen any problems?

Mr. GRIFFIN. I don't think so. We have large land masses. We have to compete with ourselves almost as much as we do with any-

body else. I really don't expect that that would happen. In fact, those other developers would probably be buying from us.

Chairman RANGEL. Ms. Ono, your situation in Hawaii is pretty much the same as the MacArthur Foundation?

Ms. ONO. That is correct.

Chairman RANGEL. You would not expect to hear cries of unfairness if the foundation was able to do without tax liability what other investors might do in terms of—what do you intend to build?

Ms. ONO. Actually we do not intend to build. We already have tenants on our properties, and what we would like to do is to debt finance and borrow money so that we can make some land improvements and provide more funds to the hospital.

Chairman RANGEL. Who occupies those buildings?

Ms. ONO. We have—if you are familiar with Hawaii, which I am sure you are, the major part in Waikiki is the international marketplace, and it is sublet, and so we do have a number of different businesses, hotels, mostly tourist industry type of shops.

Chairman RANGEL. Thank you. Thank you, Mr. Chairman.

Mr. PAYNE. Mr. Cardin.

Mr. GRIFFIN. Mr. Chairman, if I may, economic stimulus is something that is very desirable down there presently, and we could provide a significant part. It should help all of them.

Mr. PAYNE. As I understand your testimony, you have all talked about the depressed state of the real estate industry as the impetus for being here discussing this provision in the Tax Code. If the market were more robust and you had liquidity at good value, you have said that would also resolve the problem. Does this mean that we are looking at a long-term permanent change in the Tax Code to deal with what is now hopefully a temporary depression in the real estate market?

Mr. GRIFFIN. Well, there is a long-term change needed in the Tax Code. I don't think it would be useful for only an immediate stimulation. I think a long period is necessary. First, it is going to take us an immense number of years to liquidate 53,000 acres of land. Not all of it, of course, would fall into the rental category, but when you consider absorption rates down there I think that the tax relief is necessary for an extended period of time just as a practical matter, but I don't think you are bandaiding a short-term problem with a long-term solution. I think the foundation is going to need the long-term solution down there for quite a while.

Mr. KALTMAN. Mr. Chairman, we are market dependent also. However, our situation is slightly different in that our buildings are aged; they are 40 years old. Something would have to be done if they are going to be made useful at all in terms of an investment and to liquidate them now would hurt us severely.

Mr. PAYNE. Does anyone have a projected cost to the Treasury of this particular provision?

Mr. GRIFFIN. We don't have one presently. We expect to have one fairly soon. We thought actually we might see one from Treasury this morning, but that didn't turn out to be the case. It is difficult to work up the right scenarios because we have to make so many assumptions on such things as absorption and rental rates, but we will have one for you.

Mr. PAYNE. Mr. Hoagland.

Mr. HOAGLAND. Mr. Griffin, under generally accepted UBIT policy, aren't foundations not encouraged from a tax point of view to debt finance enterprises that then compete with private industry? Hasn't that been sort of the prevailing threat of UBIT for several decades?

Mr. GRIFFIN. Well, certainly the imposition of higher rates is a threat to us. We don't want to have those. I don't know if that is exactly the policy behind it, but we are out of the real estate market for all practical purposes unless we want to accept the payment of the higher rates, which we don't because we want our money to go where it belongs, to the charities, and it seems to me that the driving force that we want, the engine that we want is something that will get us more money in our hands to get to charity, not to just get it into our hands so we can stop diminishing the capital. That has been the practical impact of it, whatever the original intent of the statute was, which was really to cure a lot of abuses which we weren't party to at the time nor any other time.

Mr. HOAGLAND. I remember back when I was in law school years ago we read that Columbia University owned a macaroni plant and-NYU?

Mr. KALTMAN. NYU, Muller's Egg Noodles.

Mr. HOAGLAND. And they were making money in the macaroni plant and they were using the money to fund their charitable purposes, right?

Mr. KALTMAN. Yes.

Mr. HOAGLAND. The Supreme Court said that is inconsistent with the principles of the code at that point, but you would be asking us to carve out an exception for the McArthur Foundation for that overriding principle?

Mr. GRIFFIN. No, I don't think the overriding principle, sir. We are seeking an exception that relates to vacant land in Florida, from our standpoint anyway, that we can lease. If the idea is to prevent foundations from getting excessively into businesses, although we have to get into some to the extent of making investments, there are an awful lot of other provisions in the Code, such as the excess business holdings provisions that keep the foundation out of engaging in business regardless; we just can't get into active business.

For example, in the scenario we are talking about here, in our vacant land, we don't believe what we are asking for here would permit us to go out and subdivide those lands into individual lots and then sell them like we were selling peas out of the shell. This is strictly for rental property, effectively, od development of rental property, which is treated under a separate provision of the code and is permitted to foundations under present law, because those are what they call "passive assets or passive activity."

We can't get into active businesses. We couldn't do what I think was done in the case that you just referred to, which I wish was before my time, but I guess it wasn't.

Mr. HOAGLAND. Thank you.

Mr. PAYNE. I want to thank this panel very much for your testimony and for the answers to these questions. It is very helpful to us as we continue the legislative proceeding, and we thank you for that.

Mr. HOAGLAND [presiding]. OK. Will those individuals who are members of panel 3 take your seats? I see many of you have already. I think we will ask Mr. Leibtag—are you here, Mr. Leibtag, of the Associated Builders and Contractors, where are you? Mr. Permison, are you going to present testimony on behalf of the Associated Builders and Contractors?

Mr. PERMISON. Along with Mr. Leibtag.

Mr. HOAGLAND. All right. And then, second, we will hear from Mr. Rose; and then Mr. Padwe; and then Mr. Hamrick of the Investment Program Association; and then Mr. Corneel; and then finally Mr. Novack.

Mr. Novack, where are you?

Mr. HOAGLAND. Mr. Cardin, would you like to introduce someone?

Mr. CARDIN. Thank you, Mr. Chairman. I am very pleased to welcome two of my constituents to the committee, Bernard Leibtag and Bob Permison, who are partners in a very important, prestigious accounting firm that we have in Baltimore—Kamanitz, Uhlfelder, & Permison.

I want to thank my two constituents for bringing to my attention problems with the subchapter S corporations and efforts to try to improve the tax treatment. I am looking forward to their testimony and the other testimony of the witnesses that are before us.

But I particularly want to thank my two constituents and their firm for being very helpful to me in my work here on the committee, being always available to provide information in trying to develop my own personal positions on legislation. It is a valuable resource that I have in the Third Congressional District of Maryland.

I thank you for your public service.

Mr. HOAGLAND. OK. Thank you. Will Mr. Leibtag and Mr. Permison both be testifying?

Mr. LEIBTAG. Yes.

Mr. HOAGLAND. What I would like to ask the panel, if you might try and keep your comments to 3 minutes, if you can boil it down to 3 minutes. Now, extensions will be granted under cases of undue hardship. But I think, you know, the shorter and more concise statements are, the more attention they are likely to get. So if you could do that, although if you need to exceed, why that is certainly understandable. But if you could keep it to 3 minutes, it will help us considerably. Gentlemen, please begin.

STATEMENTS OF ROBERT PERMISON, PARTNER, AND BERNARD LEIBTAG, TAX MANAGER, KAMANITZ, UHLFELDER, & PERMISON, BALTIMORE, MD., ON BEHALF OF THE ASSOCIATED BUILDERS & CONTRACTORS, INC.

Mr. PERMISON. Thank you Mr. Chairman, honorable members of the subcommittee. My name is Bob Permison. I am a partner in the accounting firm of Kamanitz, Uhlfelder, & Permison. I am past president of the Associated Builders & Contractors, the Baltimore chapter.

Bernie Leibtag, the tax manager of our firm, joins me today, and we are pleased to testify on behalf of ABC.

ABC is a national trade association representing nearly 16,000 builders, contractors and construction suppliers. The majority of

ABC members are all small businesses. ABC believes the S corporation reforms addressed here will remove many barriers to small businesses operating as S corporations, increase capital, keep family businesses in the family, and reduce tax litigation and promote job growth.

Bernie Leibtag will comment on some specific proposals.

Mr. LEIBTAG. Thank you, Mr. Chairman and Representative Cardin. The proposals before us today will do a lot to ease the concerns that many small businesses have by simplifying S corporation law and addressing what we think is a hindrance to growth and financing sources. Our written comments have a detailed outline of the proposals.

We are specifically interested in what was, I think, originally called proposal number three on the miscellaneous S corporation provisions. It is item D–4 in the Treasury administration proposal. It is a full-blown proposal covering a number of S corporation issues. We believe that adoption of these proposals will lead to streamlining S corporation laws.

If I may, I would like to use an example, something that comes up innumerable times when dealing with our clients in terms of financing.

Current S corporation law says that shareholders in an S corporation can only have basis in their company to the extent that they lend money to their company. So when an S corporation wants to get financing, instead of having a simple financing arrangement where the bank lends the money to the S corporation and is guaranteed, as it almost always is by the shareholders, a complicated and complex arrangement is involved. Shareholders must borrow the money from the bank, then turn around and lend the coin to their corporation.

This is a costly process involving additional professional fees, additional time for the taxpayer, all to circumvent what seems to be an unnecessary barrier to raising funds. Time has to be spent teaching the bank about this rather obscure provision since the bank, of course, would prefer to lend directly to the S corporation and not to the shareholder, who then turns around and lends to the S corporation.

For smaller businesses that might not have this sophisticated tax advice, this becomes a trap for the unwary. If years later they are audited by the IRS, the IRS says, wait a second, the company borrowed the money, it doesn't matter that you guaranteed the loan: The outcome could be that the business now owes additional taxes. If the transaction had been structured properly from the beginning, this would not be an issue.

There are, of course, other provisions in here, and I am sure that the other members of the panel will touch upon these. As a representative of a trade association of closely held small businesses and a CPA practitioner, I would try to focus on just one trouble spot. We believe this and other areas can be improved by rather simple changes to the Internal Revenue Code.

We thank you for the opportunity to testify, and you know we will take any questions. Thank you.

Mr. HOAGLAND. Thank you, Mr. Leibtag.

[The prepared statement follows:]

TESTIMONY OF BERNARD LEIBTAG, CPA
TAX MANAGER, KAMANITZ, UHLFELDER & PERMISON, P.A.
REPRESENTING

ASSOCIATED BUILDERS & CONTRACTORS
1300 NORTH SEVENTEENTH STREET
ROSSLYN, VA 22209

BEFORE THE SELECT REVENUES MEASURES SUBCOMMITTEE
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

PROPOSED REFORMS OF PASS-THROUGH ENTITIES

JUNE 22, 1993

MR. CHAIRMAN AND HONORABLE MEMBERS OF THE SUBCOMMITTEE, MY NAME IS BERNARD LEIBTAG AND I AM PLEASED TO TESTIFY ON BEHALF OF THE ASSOCIATED BUILDERS AND CONTRACTORS (ABC). I AM THE TAX MANAGER OF KAMANITZ, UHLFELDER & PERMISON, AN ACCOUNTING FIRM IN BALTIMORE, MARYLAND, WHICH IS AN ASSOCIATE MEMBER OF ABC.

ABC IS A NATIONAL TRADE ASSOCIATION WHICH REPRESENTS NEARLY 16 THOUSAND BUILDERS, CONTRACTORS AND CONSTRUCTION SUPPLIERS. THE MAJORITY OF ABC MEMBERS ARE SMALL BUSINESSES. IN FACT, MORE THAN 80 PERCENT OF CONTRACTING FIRMS IN GENERAL HAVE LESS THAN 10 EMPLOYEES.

ABC SUPPORTS THE S CORPORATION REFORMS ADDRESSED TODAY BECAUSE OF THE ECONOMIC SITUATION MANY OF OUR MEMBERS ARE CONFRONTED WITH. ABC HAS MEMBERS WHO ARE STRUGGLING ON A DAILY BASIS TO KEEP THEIR BUSINESSES IN THE BLACK. THEY ARE STRUGGLING TO BUILD A BUSINESS THEY CAN PASS ON TO THEIR SONS AND DAUGHTERS, STRUGGLING TO HOLD ON TO A BUSINESS THEIR FAMILIES STARTED - - ALL AGAINST THE BACKDROP OF AN INDUSTRY THAT HAS EXPERIENCED TREMENDOUS DIFFICULTY IN THE PAST FEW YEARS.

THE LABOR DEPARTMENT REPORTED EARLIER THIS MONTH THAT 28 THOUSAND NEW CONSTRUCTION JOBS OCCURRED IN MAY. ALTHOUGH THIS INCREASE CAN BE ATTRIBUTED IN PART TO SEASONAL HIRINGS, LABOR FIGURES SHOW THAT IN THE PAST THREE MONTHS THERE HAVE BEEN 130 THOUSAND NEW CONSTRUCTION JOBS. DO NOT BE MISLED. THESE FIGURES, THOUGH SOMEWHAT ENCOURAGING, ARE DWARFED WHEN ONE RECALLS THAT CONSTRUCTION LOST NEARLY A MILLION JOBS IN THE RECENT RECESSION.

ABC APPEARS BEFORE THE COMMITTEE TODAY TO REITERATE THAT SMALL BUSINESSES RESPOND TO TAX INCENTIVES AND DISINCENTIVES. MR. CHAIRMAN, I RESPECTFULLY REQUEST YOUR LEADERSHIP IN PROMOTING POSITIVE CHANGE OF THE TAX CODE TO YOUR COLLEAGUES ON THIS SUBCOMMITTEE AS WELL AS THE FULL COMMITTEE. THE S CORPORATION

REFORMS DISCUSSED TODAY WILL HELP SMALL BUSINESSES SUCCEED AND IN TURN, CREATE JOBS. BETWEEN 1988 AND 1990, SMALL BUSINESSES CREATED 4.1 MILLION JOBS WHILE BIG BUSINESSES LOST 500 THOUSAND JOBS. WE NEED YOUR HELP AND I HOPE YOU WILL CONSIDER THE FOLLOWING RECOMMENDATIONS.

THE SUBCHAPTER S CORPORATION, WHICH IS A PASS-THROUGH ENTITY TAXING ITS OWNERS DIRECTLY ON CORPORATE PROFITS (SIMILAR TO A PARTNERSHIP), WAS ORIGINALLY INTRODUCED BY CONGRESS IN 1958. ONE OF THE MAJOR OBJECTIVES IN ESTABLISHING S CORPORATIONS WAS TO ALLOW BUSINESS OWNERS, PARTICULARLY THOSE OF SMALL BUSINESSES, TO OBTAIN THE SINGLE-TIER LEVEL OF TAXATION AFFORDED MEMBERS OF PARTNERSHIPS. AT THE SAME TIME, THEY WOULD BENEFIT BY MAINTAINING THE LIMITED LIABILITY OF A REGULAR C CORPORATION. IN 1982, SUBCHAPTER S RULES WERE REVISED IN THE SUBCHAPTER S REVISION ACT OF 1982. THE TAX REFORM ACT OF 1986 BROUGHT ABOUT TWO MAJOR CHANGES AFFECTING S CORPORATIONS. SPECIFICALLY, THE REPEAL OF THE "GENERAL UTILITIES" DOCTRINE AND A HIGHER CORPORATE RATHER THAN INDIVIDUAL TAX RATE SPURRED NUMEROUS SMALL BUSINESSES TO BECOME S CORPORATIONS. THESE TWO LEGISLATIVE CHANGES ENCOURAGED MANY BUSINESSES TO ABANDON THE TRADITIONAL 2-TIER TAXING SYSTEM OF C CORPORATIONS.

UNFORTUNATELY, CHANGES IN THE TAX RULES FOR S CORPORATIONS HAVE NOT KEPT PACE WITH THE ECONOMIC AND FINANCIAL CHANGES IN THE BUSINESS WORLD. AS A RESULT, GREATER REFORM IS NEEDED IN THIS AREA IF BUSINESSES ARE TO REALIZE THE BENEFITS CONGRESS INTENDED IN 1958. AS IT IS NOW, SMALL BUSINESSES OPERATING UNDER S CORPORATION STATUS MUST ACCEPT CERTAIN DISADVANTAGES FROM A TAX POINT OF VIEW. IN SOME CASES, BUSINESS OWNERS ARE ABLE TO OVERCOME THESE DISADVANTAGES BUT ONLY AFTER INCURRING SIGNIFICANT COSTS IN TIME AND PROFESSIONAL FEES. SMALLER BUSINESS OWNERS WITHOUT ACCESS TO SOPHISTICATED TAX ADVISORS MAY ENCOUNTER SIGNIFICANT TAX PITFALLS. ABC BELIEVES THE PROPOSALS BEFORE THIS SUBCOMMITTEE WILL GO FAR IN ALLEVIATING MANY OF THE PROBLEMS AND DISADVANTAGES FACING SMALL BUSINESSES.

***FIRST PROPOSAL** - TO ALLOW MEMBERS OF THE SAME FAMILY TO BE TREATED AS A SINGLE SHAREHOLDER FOR PURPOSES OF THE CODE'S SUBCHAPTER S RULES.*

UNDER CURRENT LAW AN S CORPORATION CANNOT HAVE MORE THAN 35 SHAREHOLDERS. ALL FAMILY MEMBERS ARE TREATED AS SEPARATE AND DISTINCT SHAREHOLDERS, EXCEPT FOR THE STOCK HELD BY A HUSBAND AND WIFE. IN THE LATTER CASE, THE COUPLE IS CONSIDERED ONE SHAREHOLDER. THE PROBLEM WITH CURRENT LAW IS THAT MANY GROWING FAMILY BUSINESSES, ESPECIALLY THOSE MOVING INTO THE SECOND AND THIRD GENERATION, CANNOT OPERATE AS S CORPORATIONS BECAUSE OF THE 35 SHAREHOLDER LIMIT. FROM AN ECONOMIC STANDPOINT, ALL FAMILY MEMBER SHAREHOLDERS ARE VIEWED AS ONE, BUT FROM A TAX SIDE THERE IS A LIMITATION.

ABC SUPPORTS THIS PROPOSAL WHICH REVISES THE RULES TO SAY ALL MEMBERS OF A FAMILY [AS DEFINED SIMILARLY IN OTHER AREAS OF THE INTERNAL REVENUE CODE, BUT SPECIFICALLY SECTION 267 (c)] SHOULD BE TREATED AS ONE SHAREHOLDER. THIS PROPOSAL WOULD ALLOW MULTI-GENERATIONAL FAMILY BUSINESSES TO CONTINUE INTO THE FUTURE AS THE NUMBER OF FAMILY SHAREHOLDERS INCREASES, WITHOUT JEOPARDIZING THE S ELECTION.

***SECOND PROPOSAL** - TO PERMIT THE OWNERSHIP OF S CORPORATION*

STOCK BY A FAMILY TRUST UNDER RULES THAT WOULD PRECLUDE SUCH TRUST OWNERSHIP FROM CIRCUMVENTING THE CURRENT LIMITATION OF NO MORE THAN 35 SHAREHOLDERS OR CAUSING INCOME TO BE TAXED AT RATES LESS THAN THE MAXIMUM INDIVIDUAL TAX RATES.

THIS PROPOSAL DOES NOT DEAL WITH THE 35 SHAREHOLDER LIMIT OR WITH CONSTRUCTIVE FAMILY OWNERSHIP THAT TREATS FAMILY MEMBERS AS ONE SHAREHOLDER.

QUITE OFTEN, FOR NON-TAX BUSINESS AND FAMILY REASONS, BUSINESS OWNERS WANT TO PLACE CORPORATE STOCK INTO A FAMILY TRUST. UNDER CURRENT LAW, THE TYPES OF TRUSTS WHICH CAN BE SHAREHOLDERS OF S CORPORATIONS ARE LIMITED. IN ADDITION, THESE TRUSTS DO NOT HAVE FLEXIBILITY SUCH AS THE POWER TO SPRINKLE DISTRIBUTIONS OR HAVE MORE THAN ONE INCOME BENEFICIARY - - BOTH IMPORTANT ASPECTS OF FAMILY TRUSTS. THIS PROPOSAL ALLOWS FAMILY TRUSTS TO BE S CORPORATION SHAREHOLDERS AND BUILDS INTO THE LAW CERTAIN SAFEGUARDS SO THE TRUST CAN NOT BE USED TO CIRCUMVENT THE 35 SHAREHOLDER LIMIT OR THE PROGRESSIVE INCOME TAX RATES ON INDIVIDUAL TRUST BENEFICIARIES.

ABC SUPPORTS THIS PROPOSAL SINCE IT WILL HELP MANY FAMILY BUSINESSES TRANSFER THE BUSINESS TO FUTURE GENERATIONS AND PROTECT THOSE BUSINESSES BY USE OF A TRUST.

<u>THIRD PROPOSAL</u> - A PROPOSAL TO MODIFY CURRENT-LAW LIMITATIONS ON S CORPORATIONS, INCLUDING THE LIMITATIONS WITH RESPECT TO THE NUMBER OF SHAREHOLDERS, ISSUANCE OF PREFERRED STOCK, ISSUANCE OF DEBT INSTRUMENTS AND FRINGE BENEFIT RULES.

THIS PROPOSAL IS THE MOST SWEEPING OF THE THREE AND GETS TO THE HEART OF MANY OF THE CURRENT DEFICIENCIES IN THE SUBCHAPTER S AREA.

a. CLEARLY, THE LIMITATION ON THE NUMBER OF S CORPORATION SHAREHOLDERS SHOULD BE REPEALED. PARTNERSHIPS CAN HAVE AN UNLIMITED NUMBER OF PARTNERS AND C CORPORATIONS AN UNLIMITED NUMBER OF SHAREHOLDERS. THE 35 SHAREHOLDER LIMIT FOR S CORPORATIONS IS AN ARTIFICIAL BARRIER THAT APPEARS TO DO LITTLE TO PROMOTE ANY STRONG PUBLIC POLICY. IT IS A HINDRANCE TO MANY SMALL BUSINESSES, PARTICULARLY THOSE THAT ARE MULTI-GENERATIONAL OR WANT TO REWARD KEY EMPLOYEES WITH STOCK OWNERSHIP OR ARE LOOKING TO ATTRACT OUTSIDE INVESTORS. ALL TOO OFTEN, S CORPORATIONS CANNOT GRANT STOCK TO VARIOUS NON-FAMILY MEMBERS BECAUSE OF THE 35 SHAREHOLDER LIMIT.

b. UNDER CURRENT LAW, S CORPORATIONS ARE ONLY ALLOWED TO HAVE ONE CLASS OF STOCK. THUS, THE ONLY STOCK THE S CORPORATION CAN ISSUE IS COMMON STOCK. THIS HURTS THE ABILITY OF S CORPORATIONS TO RAISE OUTSIDE CAPITAL.

OUTSIDE INVESTORS WHO ARE INTERESTED IN AN EQUITY POSITION IN THE CORPORATION WANT SOME TYPE OF PREFERRED RETURN ON THEIR INVESTMENT. WITH A REGULAR C CORPORATION, THIS PREFERRED RETURN IS POSSIBLE THROUGH THE RECEIPT OF PREFERRED STOCK. HOWEVER, WITH AN S CORPORATION, OUTSIDE VENTURE CAPITALISTS CANNOT RECEIVE PREFERRED STOCK. THIS IMPEDES CAPITAL FORMATION AND THE GROWTH OF SMALL BUSINESSES.

IN ADDITION, FAMILY BUSINESSES HAVE TRADITIONALLY GIVEN PREFERRED STOCK TO RETIRING SHAREHOLDERS IN EXCHANGE FOR THEIR

COMMON STOCK. THIS PROVIDES THE RETIRING SHAREHOLDER WITH A SPECIFIED RETURN, WHILE AT THE SAME TIME IT KEEPS CONTROL OF THE COMPANY FOR A NEW GENERATION. UNDER CURRENT LAW, S CORPORATIONS ARE PREVENTED FROM DOING THIS SINCE THEY ARE UNABLE TO ISSUE PREFERRED STOCK.

c. ONE OF THE MAJOR STUMBLING BLOCKS UNDER CURRENT LAW DEALS WITH S CORPORATION DEBT. AT PRESENT S CORPORATION SHAREHOLDERS HAVE BASIS FOR RECOGNIZING LOSSES TO THE EXTENT OF STOCK ISSUED TO THEM, THROUGH ACCUMULATED UNDISTRIBUTED S CORPORATION EARNINGS AND THROUGH LOANS THEY MAKE TO THE S CORPORATION. IF THE S CORPORATION BORROWS MONEY DIRECTLY FROM A BANK USING PERSONAL GUARANTEES BY THE SHAREHOLDERS, SUCH DEBT IS NOT INCLUDED IN STOCKHOLDER BASIS. IN THE PARTNERSHIP CONTEXT, SUCH RECOURSE DEBT, I.E. PARTNERSHIP DEBT GUARANTEED BY THE INDIVIDUAL PARTNERS, GIVES BASIS TO THE PARTNERS. SMALL BUSINESS OWNERS MUST ENTER INTO EXTREMELY COMPLICATED LOAN TRANSACTIONS IN ORDER TO HAVE BASIS TO ABSORB LOSSES, ESPECIALLY THOSE IN THE START-UP YEARS. THE ABILITY TO DEDUCT START-UP LOSSES IS OFTEN A BIG CONSIDERATION FOR THE BUSINESS OWNER CONTEMPLATING A NEW VENTURE.

THE MOST COMMON TRANSACTION OCCURS WHEN A BANK LOANS MONEY DIRECTLY TO THE SHAREHOLDER. THE SHAREHOLDER THEN TURNS AROUND AND LENDS THE MONEY TO THE CORPORATION PLEDGING HIS/HER STOCK, ALONG WITH OTHER GUARANTEES. THE ECONOMICS OF THE TRANSACTION ARE IDENTICAL TO A BANK LENDING MONEY DIRECTLY TO A CORPORATION, WITH THE INDIVIDUAL SHAREHOLDERS GIVING THEIR PERSONAL GUARANTEES. THE MORE COMPLICATED TRANSACTION, HOWEVER, IS USUALLY PERFORMED BECAUSE OF TAX REASONS. IN ESSENCE, FORM IS EMPHASIZED OVER SUBSTANCE. THE TIME AND COSTS OF ENTERING INTO THE ADDITIONAL TRANSACTIONS CAN BE SUBSTANTIAL. QUITE OFTEN THE S CORPORATION SHAREHOLDERS AND THEIR ADVISORS FIND THEMSELVES EXPLAINING TO THE BANK THAT THE TRANSACTION MUST BE DONE IN THIS COMPLICATED MANNER, OTHERWISE THE S CORPORATION IS UNABLE TO UNDERTAKE THE TRANSACTION. AS WITH OTHER PROVISIONS OF CURRENT S CORPORATION LAW, THE UNSOPHISTICATED S CORPORATION OWNER WHO IS NOT AWARE OF THE PROVISION MAY ENTER INTO A NORMAL BANK LOAN WITH PERSONAL GUARANTEES. UPON AN IRS AUDIT HE/SHE WILL DISCOVER THAT HE/SHE HAS NO BASIS FOR THE LOSSES.

d. CURRENTLY S CORPORATIONS ARE ONLY ALLOWED ONE CLASS OF STOCK. UNDER THE DEBT/EQUITY RULES, IT IS POSSIBLE FOR DEBT TO BE RECLASSIFIED AS EQUITY. S CORPORATION DEBT THAT IS RECLASSIFIED AS EQUITY WOULD BE TREATED AS A SECOND CLASS OF STOCK. THIS WOULD LEAD TO THE TERMINATION OF THE CORPORATION'S S ELECTION.

CERTAIN PROVISIONS IN THE CURRENT LAW ALLOW FOR "SAFE HARBOR DEBT." "STRAIGHT DEBT" OR DEBT DEFINED AS HAVING AN INTEREST RATE NOT DEPENDENT ON CORPORATE PROFITS, NOT CONVERTIBLE INTO STOCK AND NOT ISSUED TO INELIGIBLE SHAREHOLDERS, CANNOT BE RECLASSIFIED AS A SECOND CLASS OF STOCK. CONSEQUENTLY, FINANCIAL INSTITUTIONS, WHO CANNOT BE S CORPORATION SHAREHOLDERS, ARE PREVENTED FROM MAKING LOANS WHICH WOULD BE TREATED AS SAFE HARBOR DEBT. THIS LIMITS THE ABILITY OF S CORPORATIONS TO OBTAIN FINANCING. THERE APPEARS TO BE NO PUBLIC POLICY SERVED BY LIMITING THE GROUP OF LENDERS WHO CAN AVAIL THEMSELVES TO THE SAFE HARBOR DEBT PROVISIONS.

e. SIMILARLY, CURRENT "STRAIGHT DEBT" RULES DO NOT ALLOW THE

DEBT TO BE CONVERTIBLE. IN MOST CASES, CONVERTIBLE STRAIGHT DEBT WOULD BE CONSIDERED A SECOND CLASS OF STOCK. THE STRAIGHT HARBOR DEBT PROVISIONS SHOULD BE EXPANDED SO THAT CONVERTIBLE STRAIGHT DEBT CAN BE ISSUED. THESE TWO DEBT PROPOSALS WILL INCREASE S CORPORATION FINANCING ALTERNATIVES.

f. IN THE AREA OF FRINGE BENEFITS, S CORPORATION SHAREHOLDERS ARE NOT TREATED AS EMPLOYEES OF A REGULAR C CORPORATION BUT INSTEAD LIKE PARTNERS IN A PARTNERSHIP. THIS LIMITS THE ABILITY OF THE BUSINESS OWNERS TO OBTAIN FRINGE BENEFITS WHICH WOULD NORMALLY BE AVAILABLE TO THEM AS SHAREHOLDERS OF A C CORPORATION. THE MOST SIGNIFICANT OF THESE BENEFITS IS THE RECEIPT OF TAX-FREE MEDICAL INSURANCE COVERAGE (IRC SEC. 105) AND GROUP TERM LIFE INSURANCE UP TO $50 THOUSAND DOLLARS (SECTION 79).

WITH RESPECT TO THE THIRD PROPOSAL, ABC RECOMMENDS CHANGES IN ALL THESE AREAS TO MAKE S CORPORATIONS A MORE WORKABLE CHOICE OF BUSINESS ENTITY.

ONE LAST POINT THAT I WOULD LIKE TO MENTION. S CORPORATIONS ARE ALSO ADVERSELY AFFECTED BY THE LOOKBACK RULES UNDER IRS CODE SECTION 1.460-6(d) . THIS SECTION EXPLAINS THE CIRCUMSTANCES UNDER WHICH THE SIMPLIFIED MARGINAL IMPACT METHOD MUST BE APPLIED AT THE ENTITY LEVEL FOR PASS-THROUGH ENTITIES. THIS IS REQUIRED FOR DOMESTIC CONTRACTS REPORTED BY PASS-THOUGH ENTITIES THAT ARE NOT CLOSELY HELD. IF THE ENTITY IS CLOSELY HELD, IT IS NOW PERMITTED TO USE THE SIMPLIFIED MARGINAL IMPACT METHOD UNDER THESE REGULATIONS BUT CANNOT USE THIS ELECTED METHOD AT THE ENTITY LEVEL.

ABC BELIEVES THAT ALL PASS-THROUGH ENTITIES, INCLUDING S CORPORATIONS, SHOULD BE PERMITTED TO ELECT UTILIZATION OF THE SIMPLIFIED MARGINAL IMPACT METHOD AT THE ENTITY LEVEL. THIS WILL SIMPLIFY THE SECOND STEP OF THE LOOKBACK METHOD AS INTENDED BY THE PROVISION.

TO TRULY AID THE SMALL CONTRACTOR DOING BUSINESS AS AN S CORPORATION, WE ONCE AGAIN RECOMMEND, AS ABC DID AT PREVIOUS WAYS AND MEANS HEARINGS IN 1991, THAT SMALL CONTRACTORS NOT BE COMPELLED TO PERFORM COMPLEX LOOKBACK COMPUTATIONS FOR ALTERNATIVE MINIMUM TAX PURPOSES.

THANK YOU AGAIN FOR THE OPPORTUNITY TO SPEAK ON THESE ISSUES. I WILL BE HAPPY TO ANSWER ANY QUESTIONS.

Mr. HOAGLAND. I see that a number of you on this panel will be discussing this subchapter S issue. You all had an opportunity to review Treasury's recommendation with respect to this, and maybe we could work in Mr. Padwe in 10 seconds or so addressing those. Because Treasury, as you see from their paper here—we will share this with you if you haven't seen it—recommends either their lowest or second lowest level of support for this series of recommendations.

Basically, they seem to say we should do a comprehensive study of the subchapter S issues before tinkering. So if you all might give the committee your views on that, maybe there are some things we could do quickly that would be of considerable benefit without waiting.

Mr. Rose.

STATEMENT OF JORDAN P. ROSE, PARTNER, STEEFEL, LEVITT & WEISS, SAN FRANCISCO, CALIF., AND VICE CHAIR, COMMITTEE ON S CORPORATIONS, AMERICAN BAR ASSOCIATION, SECTION OF TAXATION

Mr. ROSE. Thank you, Mr. Chairman and members of the committee. Good afternoon. My name is Jordan Rose, partner in the San Francisco law firm of Steefel, Levitt & Weiss. I am also vice chair of the S Corporation Committee of the American Bar Association, Tax Section, and former chair of its Subcommittee on Legislative Recommendations. That subcommittee authored the approximately 80-page draft report which serves as the foundation document for many of the S corporation proposals which are being considered by this committee.

As noted in my written statement, neither the American Bar Association nor the Taxation Section has acted upon or approved the views expressed by me today, and accordingly, I am speaking in my individual capacity.

Concerning the comments that were made by Mr. Samuels this morning, with respect to which the chairman has requested we comment, I think it is worth considering how we got to be here. The comment that the proposals require further deliberation, study and analysis. I submit that the proposals have been thoroughly studied, analyzed and considered.

This all started back in early 1990 when the then Chief of Staff of the Joint Committee on Taxation, Ron Perlman, approached the American Bar Association's S Corporation Committee and asked that we submit suggestions on how to improve and simplify subchapter S. He requested that we specifically address the stumbling blocks that existed in electing and operating under subchapter S and the main reasons that corporations that would otherwise qualify did not do so.

The S Corporation Committee identified four principal problem areas. First is the limitation on ownership, including the types of trusts that are eligible to be shareholders of an S corporation and the number of shareholders. These limitations essentially rendered estate planning very difficult for the owners and entrepreneurs, and jeopardized the continuation of family-owned businesses through the next generations.

The second stumbling block is that S corporation's access to capital is limited, due to the second class of stock restrictions and the limitations on the type of debt instruments that S corporations can issue. This negatively impacts the ability of S corporations to expand and interfered with their ability to compete effectively with other businesses.

The third problem we saw is the inability of S corporations to operate through subsidiaries which prevents effective business planning and precludes achieving legitimate nontax objectives. The effect of this is that the S corporation is discouraged from operating additional businesses that could expose the assets of their principal business to liabilities and risk of a startup venture.

Fourth is the existence of many tax traps for the unwary.

After identifying these four principal problem areas, members of the S Corporation Committee met with staff of the Joint Committee on Taxation, and the message was that there was some desire on the part of Congress to perhaps expand subchapter S as a feature of a more fully integrated tax system. We went through a number of proposals that Joint Committee staff and members of the committee thought were appropriate, and those are detailed in my written statement.

After that meeting, the members of the S corporation committee submitted proposals to the Joint Committee and met informally with representatives of the Treasury Department, House Ways and Means Committee and Senate Finance Committee and presented the proposals for simplification and improvement of subchapter S which are contained in that 80-page draft report that I mentioned earlier.

Eventually, the Tax Simplification Act was introduced in the House and the Senate, containing a number of those proposals; and various regulations were adopted by the Internal Revenue Service, which contained a number of other of those proposals.

Subsequently, the U.S. Chamber of Commerce contacted members of the ABA's S Corporation Committee and the AICPA's S Corporation Committee and requested technical assistance from those members in developing a consensus package for the reform and improvement of subchapter S. The consensus package, which is essentially contained in the Joint Committee on Taxation pamphlet which is being considered by this committee today, embodies substantively the proposals of the S Corporation Committee of the American Bar Association Taxation Section. It also embodies the proposals of the AICPA Taxation Committee on S Corporations. These committees have voted to endorse those proposals.

In addition to the support of the U.S. Chamber of Commerce and certain other trade organizations, the consensus package has also been endorsed by the AICPA and the Washington, D.C., S Corporation Study Group.

It is clear that there has been a comprehensive, thoughtful and deliberate analysis of the tax and practical issues pertaining to the reform of subchapter S of the Internal Revenue Code. It is also clear from a professional tax practitioner's perspective that the proposals contained in the Joint Committee on Taxation pamphlet, which is the consensus package, will achieve the goals thought to be desirable and will improve and simplify subchapter S.

I would like to again thank you for the opportunity to present my views, and I stand ready, as do other members of the American Bar Association, Tax Section S Corporation Committee, to help in any way we can in achieving some meaningful reform and improvement of subchapter S.

I will be happy to answer any questions you might have.

Mr. HOAGLAND. Thank you, Mr. Rose, for your testimony.

[The prepared statement and attachments follow:]

STATEMENT
OF
JORDAN P. ROSE
BEFORE THE
SUBCOMMITTEE ON SELECT REVENUE MEASURES
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

JUNE 22, 1993

Although the undersigned is Vice-Chair of the S Corporation Committee of the American Bar Association Taxation Section, the views expressed herein have not been acted upon nor approved by the American Bar Association or the Taxation Section and, accordingly, are expressed by the undersigned in his individual capacity only.

In February 1990, then Chief of Staff of the Joint Committee on Taxation, Ron Perlman, requested that the ABA's S Corporation Committee submit suggestions on how to improve and simplify Subchapter S of the Internal Revenue Code. He requested that the S Corporation Committee address the existing stumbling blocks to electing and operating under Subchapter S, and the main reasons corporations which otherwise qualified did not utilize Subchapter S.

The S Corporation Committee identified four problem areas:

1. Limitations on the types of trusts eligible to be shareholders of an S corporation rendered estate planning difficult for the owners and entrepreneurs;

2. S corporations' access to capital was restricted due to second class of stock limitations and uncertainties, which interfered with business expansion;

3. S corporations' inability to operate through subsidiaries prevented effective business operational planning, and precluded achieving legitimate non-tax business objectives; and

4. The existence of many tax traps for the unwary.

After identifying these problem areas, members of the S Corporation Committee met with the Staff of the Joint Committee on Taxation. It appeared that there was some desire on the part of Congress to expand access to Subchapter S as a feature of a more fully integrated tax system. Several matters were specifically addressed at that meeting, including:

1. The expansion of trusts eligible to be shareholders;

2. An increase in the number of shareholders;

3. The waiver of inadvertent defective elections;

4. The satisfaction of capital needs via increased shareholder eligibility, liberalized restrictions on permissible debt, and the use of preferred stock;

5. Permitting S corporations to have C or S corporations as subsidiaries, or being a subsidiary; and

6. Eliminating the termination of S status based on excess passive income.

In response to this meeting, members of the S Corporation Committee informally submitted ten proposals to the Joint Committee on Taxation. Thereafter, members of the S Corporation Committee met with representatives of the Treasury Department, the House Ways and Means Committee and the Senate Finance Committee and presented the proposals for the simplification and improvement of Subchapter S; in June 1991, the Tax Simplification Act of 1991 was introduced in the House and the Senate containing a number of those proposals.

Subsequently, the U.S. Chamber of Commerce contacted members of the S Corporation Committee of the ABA and the S Corporation Committee of the AICPA and requested technical assistance in connection with the proposed reform of Subchapter S. Those members of the two Committees comprised a working group which, in consultation with the U.S. Chamber, developed a consensus package intended to simplify and improve Subchapter S. The consensus package, a copy of which is attached to this statement, substantively embodies the proposals of the S Corporation Committee of the American Bar Association Taxation Section. The S Corporation Committee has voted to endorse the proposals contained in the consensus package.

In addition to the support of the U.S. Chamber, the consensus package has also been endorsed by the AICPA and the Washington, D.C. S Corporation Study Group.

It is clear, from a professional tax practitioner's perspective, that the proposals contained in the consensus package will achieve desirable goals and address the problem areas identified. The undersigned has no hesitation in recommending favorable consideration of these proposals.

Respectfully submitted,

JORDAN P. ROSE

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Attachment

16420.CORR|D18379

April 1993

S CORPORATION WORKING GROUP SUMMARY OF DRAFT LEGISLATION

The S Corporation Working Group has developed this outline for an S corporation reform bill for introduction in Congress in 1993. This initiative is designed to reform the current S corporation rules and eliminate many traps for the unwary, resulting in improvements in the capital formation opportunities of small business. The legislation will also contribute to the preservation of family-owned businesses by removing impediments to the transfer of a firm from one generation to the next. By ensuring continuance of the family-owned business and through enhancement of a small firm's access to capital, the reform bill should result in an increase in jobs and prosperity for the American work force. In general, the reform bill removes arbitrary limitations on S corporation shareholders, allows S corporations to issue preferred stock under certain circumstances, expands the types of debt instruments which an S corporation may issue, treats S corporation shareholder-employees more equitably with respect to fringe benefits, and makes various other improvements.

Participants in the S Corporation Working Group include representatives of the American Bar Association S Corporation Committee, the American Institute of Certified Public Accountants S Corporation Taxation Committee, the S Corporation Tax Study Group, the U.S. Chamber of Commerce, and others. The proposed S corporation reform bill as summarized below, reflects the personal views of the participants in the S Corporation Working Group, and do not necessarily reflect the views of the organizations they represent. The proposed legislation, therefore, must be reviewed and approved by the appropriate policy committees of each organization before it can become an official position of such organization.

The S Corporation Taxation Committee of the AICPA has reviewed this report and has voted to conceptually support the proposal without reservation. The S Corporation Committee's sole concern is related to implementation issues; e.g., where S corporations would be permitted to own other S corporations. This AICPA committee has indicated that position papers will be required to evaluate these implementation issues. In addition, this summary and these position papers will require approval of the AICPA's Tax Executive Committee.[1]

With respect to the S Corporation Committee of the American Bar Association Tax Section, the committee has voted to endorse the proposals contained in this report. However, the proposals have not been acted upon or approved by the American Bar Association or its Taxation Section and accordingly, the views of the members of the

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[1] On November 20, 1992, the AICPA Tax Executive Committee approved this proposal. The Tax Executive Committee is a senior technical committee of the AICPA and is authorized to speak on behalf of the AICPA on matters related to taxation.

American Bar Association's S Corporation Committee are expressed in their individual capacity only.

The S Corporation Tax Study Group has also reviewed this report, and conceptually supports the proposals contained in the reform initiative. However, they too have noted that implementation and other issues will arise when these proposals are reduced to legislative language.

Further, the U.S. Chamber's Taxation Committee has reviewed this report, and has voted to generally support the proposals.

SHAREHOLDER LIMITATIONS

1. Thirty five shareholder limitation.

Current Law: Among other criteria, an S corporation election is not valid if the business has more than 35 shareholders.

Problem: For multi-generational family-held businesses, an artificial limit on the number of shareholders prevents corporations from continuing to operate as an S corporation for future generations. Also, some high-tech corporations that want to reward key employees are artificially limited to a thirty-five shareholder limitations.

> Example: A furniture manufacturing company now owned by the second and third generations of the two founding families is an S corporation. Currently they have 25 shareholders. Mathematically, the S corporation status will not be able to be continued into the next generation.

Recommendation: The current S corporation limit of 35 shareholders is an arbitrary standard which serves to restrict capital formation opportunities of smaller firms. The S Corporation Working Group recommends that the current limit be raised to 50 shareholders. (This proposal was included as a measure in H.R. 11, the Revenue Act of 1992.)

LEGISLATIVE LANGUAGE: H.R. 11 § 7601(a).

> (a) S Corporations Permitted to Have 50 Shareholders.—Subparagraph (A) of section 1361(b)(1) (defining small business corporation) is amended by striking "35 shareholders" and inserting "50 shareholders".

2. Permit tax exempt organizations as eligible shareholders.

Current Law: A tax exempt organization is not an eligible shareholder for purposes of a valid S corporation election.

Problem: Tax exempt organizations including pension plans, ESOPs (a qualified employee stock ownership plan), university endowment funds are a significant source of capital for small closely-held businesses seeking to expand their operations. Because tax exempt organizations are ineligible shareholders, these sources of capital are unavailable to S corporations. This places them at a competitive disadvantages to C corporations.

> Example: The founder of an S corporation wants to retire and would like to sell the business to its employees. To obtain the financing required for an employee purchase, a C corporations would normally establish an ESOP. However, this S corporation owner will likely be forced to sell to outside interests and not to the employees because an ESOP is an ineligible shareholder.

Recommendation: The Group recommends that tax exempt organizations become eligible to hold stock in S corporations. This proposal would allow the partnership flow-through approach to be used with exempt organization shareholders of an S corporation. For example, any trade or business income allocable to the exempt organization shareholder would be subject to the unrelated business income tax, or UBIT, but interest and dividend income would not.

LEGISLATIVE LANGUAGE: No Legislative Language.

3. Allow nonresident alien shareholders as eligible shareholders.

Current Law: A nonresident alien is not an eligible shareholder for purposes of a valid S corporation election.

Problem: Frequently, sources of capital or entre to foreign markets requires an equity participation of a nonresident alien.

> Example: A local S corporation manufacturer has an opportunity to expand sales into the European market. A European individual who will manage oversees marketing wants to invest in a minority equity position in the company. The restriction on ownership of S corporation stock by nonresident shareholders forces the manufacturer to either give up its S corporation status or resort to unnecessarily sophisticated and expensive tax planning techniques.

Recommendation: The Group recommends that nonresident aliens (individuals only) be treated as eligible shareholders. Under this recommendation, any effectively connected U.S. income allocable to the nonresident alien should be subject to a withholding tax similar to the tax imposed on nonresident partners of a partnership.

LEGISLATIVE LANGUAGE: ABA Proposal to amend §§ 875, 894, 1361(b)(1)(C), and 1446.

SECTION 875:

[Sec. 875]

SEC. 875. PARTNERSHIPS; S CORPORATIONS; BENEFICIARIES OF ESTATES AND TRUSTS.

For purposes of this subtitle--

(1) a nonresident alien individual or foreign corporation shall be considered as being engaged in a trade or business within the United States if the partnership or S corporation of which such individual or corporation is a member or shareholder is so engaged, and ...

SECTION 894:

[Sec. 894(c)]

(c) PERMANENT ESTABLISHMENT OF PARTNERS AND S CORPORATION SHAREHOLDERS.- A nonresident alien individual or foreign corporation which is a partner of a partnership, or a nonresident alien individual who is a shareholder of an S corporation, which partnership or S corporation has a permanent establishment in the United States during the taxable year within the meaning of a treaty to which the United States is a party, shall be deemed to have a permanent establishment in the United States within the meaning of such treaty.

SECTION 1361(b)(1)(C):

[Sec. 1361(b)]

(b) SMALL BUSINESS CORPORATION.--

~~(C) have a nonresident alien as a shareholder, and~~

4. Expand the types of trusts permitted to be S corporation shareholders.

Current Law: Only certain types of trusts are permitted to become shareholders of an S corporation. The two most common types of eligible trust shareholders include the grantor trust and the "qualified subchapter S trust" (QSST).

Problem: The most common trusts used for estate planning purposes have multiple beneficiaries and sprinkling powers vested in the trustee. These trusts are not allowed to hold S corporation stock. As a result, S corporation shareholders do not have access to the same estate planning techniques available to C corporation owners.

> Example: A S corporation owner has an ailing spouse and several children. To properly provide for the family at the owner's death, the owner will probably want to use a trust that allows the trustee to make distributions to care for the medical needs of the ailing spouse and the varying educational needs of the children. To accomplish this, the owner will need to terminate S corporation status or result to unnecessarily complicated and expensive estate planning techniques.

Recommendation: The Group recommends expansion of the definition of what constitutes a QSST. Under this expanded definition, single-tier trusts would be permitted to have multiple income beneficiaries and to accumulate income from the S corporation at the trust level. Sprinkle trusts would be treated as eligible S corporation shareholders. Multiple beneficiaries would each, along with the trust, be counted as shareholders. However, the family attribution rules would apply in counting the number of shareholders.

LEGISLATIVE LANGUAGE: No Legislative Language.

CONSTRUCTIVE OWNERSHIP

1. Shareholder counting conventions -- application of constructive ownership rules.

Current Law: Only a husband and wife are treated as one shareholder for purposes of the S corporation election. All other members of a family are treated as separate shareholders.

Problem: For multi-generational family-held businesses, an artificial limit on the number of shareholders prevents corporations from continuing to operate as an S corporation for future generations.

Example: A furniture manufacturing company now owned by the second and third generations of the two founding families is an S corporation. Currently they have 25 shareholders. Mathematically, the S corporation status will not be able to be continued into the next generation. Under this proposal, solely for purposes of the 35-shareholder limitation, the corporation would be treated as having only two shareholders. For all other purposes, all actual shareholders would be treated as shareholders.

Recommendation: The Group recommends that the family attribution rules under Code section 267(c)(4) apply in the situation of the S corporation election. This means that all family members would be treated as one S corporation shareholder.

LEGISLATIVE LANGUAGE: ABA proposal to amend § 1361(c)(1).

SECTION 1361:

[Sec. 1361(c)]

(c) SPECIAL RULES FOR APPLYING SUBSECTION (b).--

(1) ~~HUSBAND AND WIFE~~ FAMILY MEMBERS TREATED AS 1 SHAREHOLDER.--For purposes of subsection (b)(1)(A), ~~a husband and wife~~ members of the same family (as defined in section 267(c)(4)) and their estates shall be treated as one shareholder.

PREFERRED STOCK

1. **Permit S corporations to issue preferred stock.**

Current Law: An S corporation is permitted to have only one class of stock.

Problem: Venture capitalists and other outside sources of funding generally require an equity position that provides a preferred return with the upside potential for capital gain to enhance the rate of return on investment.

Example: A small S corporation has developed a promising new product. To bring it to market, they require outside investment capital. They have exhausted family and commercial bank sources of capital and now seek venture capital. As an S corporation, they are precluded from offering venture capitalists an economically attractive investment opportunity.

Recommendation: The Group recommends that S corporations be permitted to issue preferred stock, including convertible preferred stock. Under this proposal, only eligible S corporation shareholders would be allowed to own preferred stock.

LEGISLATIVE LANGUAGE: ABA proposal to amend § 1361(c)(7). [Note: The ABA proposal would allow for convertible preferred stock, without specifically so stating. However, the Working Group would prefer that the statute explicitly permit stock with a convertibility feature to qualify.]

SECTION 1361:

[Sec. 1361(c)]

(7) QUALIFIED PREFERRED STOCK. For purposes of this subchapter, the term "qualified preferred stock" shall mean stock, which is identical to the corporation's issued and outstanding common stock except that the holders thereof are entitled to receive a specified minimum amount and/or percentage of the corporation's earnings prior to any distributions to the holders of the corporation's common stock.

SUBSIDIARIES

1. Permit an S corporation to own more than 80 percent of another corporation's stock.

Current Law: An S corporation may own as much as 79 percent of the stock of another corporation without jeopardizing the S election.

Problem: For valid nontax business reasons, corporations frequently establish subsidiaries to hold their different business activities. Normally, these would be wholly-owned subsidiaries. An S corporation is precluded from using this ownership structure because of the prohibition on affiliated companies. Currently, this business goal can only be accomplished by using inefficient and costly tax planning techniques.

Example: A local general construction company, organized as an S corporation, has developed expertise in asbestos abatement and removal. However, concerns about potential liability exposure may cause the corporation to withdraw from this business, unless it can be dropped into a subsidiary.

Recommendation: The group believes that a corporation should be permitted to elect S status regardless of the percentage of stock that it owns in a C corporation

subsidiary. However, the S corporation would not be permitted to participate in any consolidated returns. (This proposal was included as a measure in H.R. 13, the Tax Simplification Act of 1993.)

LEGISLATIVE LANGUAGE: H.R. 13 § 603(b).

(b) S Corporations Permitted To Hold Subsidiaries.—
(1) In General.—Paragraph (2) of section 1361(b) (defining ineligible corporation) is amended by striking subparagraph (A) and by redesignating subparagraphs (B), (C), (D), and (E) as subparagraphs (A), (B), (C), and (D), respectively.
(2) Conforming Amendments.—
(A) Subsection (c) of section 1361 is amended by striking paragraph (6).
(B) Subsection (b) of section 1504 (defining includible corporation is amended by adding at the end thereof the following new paragraph:
"(8) An S corporation."

2. **Permit S corporations to own S corporation stock.**

Current Law: S corporations are not permitted to have corporate shareholders.

Problem: While the preceding proposal would allow wholly-owned subsidiaries, those subsidiaries would be denied flowthrough treatment. (The subsidiary could not itself be an S corporation because S corporations cannot have corporations as shareholders.) This defeats the objective of subchapter S in permitting flowthrough treatment for the entire business.

In the preceding example, the asbestos subsidiary, if organized, would be restricted to C corporation status. It is inappropriate to deny flowthrough treatment where business reasons necessitate the use of a subsidiary. To obtain flowthrough treatment under current law, the owners of the construction company could form a new "sister" corporation to engage in the asbestos removal business. This alternative is an unnecessarily inefficient and costly corporate structure.

Recommendation: The Group recommends that an S corporation be permitted to own 100 percent of the stock of another S corporation, as well as a chain of S corporations. The corporate group would not be permitted to file consolidated returns.

LEGISLATIVE LANGUAGE: No legislative language.

DEBT

1. Expand safe harbor debt to permit convertible debt.

Current Law: It is possible that debt may be recharacterized as a second class of stock. However, an obligation that qualifies as "straight debt" is not considered a second class of stock and thus, does not trigger a violation of the S election. For example, if the debt contains conversion and liquidation rights, the entity's S election could be in jeopardy.

Problem: Debt instruments frequently contain convertibility features. Under current law, S corporations are at risk that this convertible debt could be construed as a "second class of stock" which would terminate S status. This common debt feature should not terminate S status. While current regulations offer some flexibility, these rules do not adequately resolve this problem.

Recommendation: The "safe harbor debt" provisions of the tax law dealing with S corporations should be expanded to allow the issuance of convertible debt. However, the debt instrument in question must continue to meet all of the other criteria of straight debt.

LEGISLATIVE LANGUAGE: ABA proposal to replace current § 1361(c)(5)(B) with...

SECTION 1361:

[Sec. 1361(c)(5)]

(B) STRAIGHT DEBT DEFINED.--For the purposes of this paragraph, the term "straight debt" means any written unconditional promise to pay on demand or on a specified date a sum certain money if the interest rate (and interest payment dates) are not contingent on profits, the borrower's discretion, or similar factors; provided, however, that if the terms of such promise include a provision whereby the obligation to pay may be converted (directly or indirectly) into or subordinated to stock of the corporation, such terms, taken as a whole, must not be materially different than the terms which could have been obtained on the effective date of the promise from an unrelated party in the trade or business of lending money or providing capital financing.

2. Permit ineligible shareholders to hold safe harbor debt.

Current Law: The Tax Code does not treat debt as a second class of stock if the obligation meets certain requirements. This particular type of debt is called "safe

harbor debt." For purposes of safe harbor debt, the creditor must be an individual, an estate, or a trust which is eligible to be an S corporation shareholder.

Problem: A loan from a financial institution would not be treated as safe harbor debt.

Recommendation: To expand financing opportunities for S corporations, the Group believes that loans from financial institutions and other lenders should not be subjected to greater restrictions than loans made by others. Therefore, the Group recommends that loans from lenders be treated as safe harbor debt provided that the loan meets all other requirements for safe harbor debt.

LEGISLATIVE LANGUAGE: ABA proposal to replace current § 1361(c)(5)(B). (See immediately preceding proposal.)

3. **Permit shareholder personal guarantees of corporate debt to increase shareholder basis.**

Current Law: A partner includes his share of partnership indebtedness in his basis (in the partnership) for loss deduction purposes. In contrast, an S corporation shareholder is not permitted to include indebtedness of the S corporation in his stock basis, even to the extent the shareholder has provided a personal guarantee of the corporate debt.

Problem: Current law emphasizes form over substance. When an S corporation needs additional funds, typically a commercial bank will make the loan directly to the corporation with the additional security of a shareholder guarantee. A well-advised S corporation owner would structure the financing arrangement so that the bank would make the loan to the shareholder who would then reloan the borrowed funds to the corporation. In both cases, the shareholder is economically exposed to repay the loan to the bank. Yet, basis is available only if the shareholder is well-advised before the loan is made.

> Example: An S corporation nursery and landscaping business needs additional funds for expansion. The corporation borrows from a bank and the owner personally guarantees the debt. The guarantee does not increase the owner's basis. If the owner had first incurred the expense of consulting a tax advisor, the advisor would have recommended using "back-to-back" loans, which could have resulted in basis to the shareholder without any economic difference to any party -- except for the fee paid to the tax advisor.

Recommendation: The Group recommends that to the extent an S corporation shareholder personally guarantees indebtedness of the S corporation, the shareholder

should be permitted to reflect the personal guarantee as part of his basis in the entity for loss deduction purposes.

LEGISLATIVE LANGUAGE: ABA proposal to amend §§ 1366(d)(2), (d)(4), and 1368(f). But note this does not reflect last week's discussion regarding single guarantor/single note safe harbor guarantee.

SECTION 1366:

[Sec. 1366(d)]

(d) SPECIAL RULES FOR LOSSES AND DEDUCTIONS.–

(1) CANNOT EXCEED SHAREHOLDER'S BASIS IN STOCK AND DEBT.–The aggregate amount of losses and deductions taken into account by a shareholder under subsection (a) for any taxable year shall not exceed the sum of –

(A) the adjusted basis of the shareholder's stock in the S corporation (determined with regard to paragraphs (1) and 2(A) of section 1367(a) for the taxable year), ~~and~~

(B) the shareholder's adjusted basis of any indebtedness of the S corporation to the shareholder (determined without regard to any adjustment under paragraph (2) of section 1367(b) for the taxable year), and

(C) the shareholder's guaranteed debt basis described in paragraph 4 of this section 1366(d).

• • • •

(4) GUARANTEED DEBT BASIS.–A shareholder's guaranteed debt, basis shall equal the amount of the corporation's guaranteed debt, as defined in Subparagraph (a), for which the shareholder has provided a personal guarantee or is otherwise personally liable for repayment times a fraction, the numerator of which is the number of shares in the corporation owned by the shareholder, and the denominator of which is the number of shares in the corporation owned by all shareholders who have provided personal guarantees or who are personally liable for such debt.

(A) GUARANTEED DEBT.–The term "guaranteed debt" shall refer to any debt of the corporation to a lender who is not a related person with respect to either the corporation or any of its shareholders on account

of which one or more shareholders have provided a personal guarantee or are otherwise personally liable for repayment of such debt.

(B) RELATED PERSON.--For purposes of subparagraph (A), a person (hereinafter in this paragraph referred to as the "Related Person") is related to the corporation or any of its shareholders if the Related Person bears a relationship to the corporation or any of its shareholders specified in section 267(b) or section 707(b)(1). For purposes of applying sections 267(b) or 707(b)(1), "10%" shall be substituted for "50%" throughout each of those sections.

(C) EXCEPTION.--In no instance shall any shareholder be deemed to have personally guaranteed or to be personally liable for repayment of the corporation's debt to a lender in respect to any portion of any debt of the corporation as to which the shareholder is not personally liable, through guarantee or otherwise, or is protected against loss through nonrecourse financing a stop loss agreement, indemnification, or other similar arrangements. The relative financial resources of the shareholders shall not be considered in determining whether any shareholder is protected from loss.

In the case of any distribution made during any taxable year, the adjusted basis of stock shall be determined with regard to the adjustments provided in paragraph (1) of section 1367(a) for the taxable year.

* * * *

SECTION 1368:

[Sec. 1368(f)]

(f) RELIEF OF GUARANTEED DEBT DEEMED DISTRIBUTION.-- If a shareholder has guaranteed debt basis (as adjusted pursuant to section 1367(b)) and is relieved of all or a portion of the S corporation's guaranteed debt, as defined in subparagraph (A) of paragraph (4) of section 1366(d) due to indemnification, satisfaction or otherwise, then the portion of the guaranteed debt from which the shareholder is relieved shall be deemed to be a distribution by the S corporation during the tax year of the corporation during which the guarantee relief occurs and subject to the rules of subsection (a) to the extent the shareholder's pro rata share of the guaranteed debt, determined as described in section 1366(d)(4), exceeds the shareholder's guaranteed debt basis, as adjusted pursuant to subparagraphs (A) and (B) of paragraph (2) of section 1367(b).

PASSIVE INVESTMENT INCOME

1. Repeal excessive passive investment income as a termination event.

Current Law: Subchapter S contains two disincentives to discourage "incorporated pocketbooks" from operating as S corporations. First a corporate level tax is imposed on excess passive investment income. Second, S status is terminated if the corporation earns passive investment income that exceeds 25 percent of the entity's gross receipts for three consecutive taxable years and the entity has accumulated Subchapter C earnings and profits at the end of each of the three years.

Problem: While this result may be avoided through proper tax planning, many unadvised S corporations are caught unaware of these traps and lose their S status. The sanction of terminating S status when the entity has excessive passive income is unduly harsh.

> Example: Due to business fluctuations, the operating business of an S corporation declines over a period of several years. During the recession, a substantial portion of the corporation's income is derived from passive sources. Without proper advice, this corporation may not realize that its S status will terminate if this situation continues for three years.

Recommendation: To the extent Congressional intent is to limit the passive income of an S corporation, the Group believes this legislative intent is sufficiently served through the current procedures of imposing a corporate level tax on the S corporation's passive income. Therefore, the sanction of terminating the S election in the situation of excessive passive income should be repealed.

LEGISLATIVE LANGUAGE: ABA proposal to amend §1362(d)(3).

SECTION 1362:

[Sec. 1362(d)(3)]

To be deleted in its entirety.

2. Exclude trade or business income from the passive investment income definition.

Current Law: The definition of passive investment income for S corporation purposes includes the types of income earned by a personal holding company, and many traditional types of active trade or business income earned by an operating company.

Problem: By including certain types of active trade or business income in the passive investment income definition, many operating companies are precluded from making the S election.

Examples: Examples of such operating companies include certain rental real estate operators and certain corporations earning royalty income from the franchising of a product, process, or service.

Recommendation: The Group recommends that the income earned from the active conduct of a trade or business should not be included in the S corporation definition of passive income. It is recommended that a facts and circumstances test be adopted to determine what constitutes active as opposed to passive income. Examples of regulations that may be used in drafting a facts and circumstances test include Regulation sections 1.355-3(b) and 1.469-2T(c)(3)(i).

LEGISLATIVE LANGUAGE: No legislative language.

ELECTIONS

1. Permit the Secretary of Treasury to treat invalid elections as effective.

Current Law and Problem: The IRS has the authority to waive the effect of an inadvertent S corporation termination, but not the authority to waive the effect of an invalid election caused by an inadvertent failure to qualify as an S corporation.

Recommendation: The Group believes that the IRS should have the authority to waive an inadvertent invalid S corporation election for entities that have subsequently cured the defect. This new authority would be a broadening of the current IRS authority to waive the effect of an inadvertent S corporation termination. (H.R. 13 includes a measure to cure inadvertent S corporation elections.)

LEGISLATIVE LANGUAGE: H.R. 13 §§ 601 (a) and (b).

SEC. 601. AUTHORITY TO VALIDATE CERTAIN INVALID ELECTIONS.

(a) General Rule.—Subsection (f) of section 1362 (relating to inadvertent terminations is amended to read as follows:

"(f) Inadvertent Invalid Elections or Terminations.—If—

"(1) an election under subsection (a) by any corporation—

"(A) was not effective for the taxable year for which made (determined without regard to subsection (b)(2)) by reason of a failure to meet the requirements of section 1361(b) or to obtain shareholder consents, or

"(B) was terminated under paragraph (2) or (3) of subsection (d),

"(2) the Secretary determines that the circumstances resulting in such ineffectiveness or termination were inadvertent,

"(3) no later than a reasonable period of time after discovery of the circumstances resulting in such ineffectiveness or termination, steps were taken—

"(A) so that the corporation is a small business corporation, or

"(B) to acquire the required shareholder consents, and

"(4) the corporation, and each person who was a shareholder in the corporation at any time during the period specified pursuant to this subsection, agrees to make such adjustments (consistent with the treatment of the corporation as an S corporation) as may be required by the Secretary with respect to such period,

then, notwithstanding the circumstances resulting in such ineffectiveness or termination such corporation shall be treated as an S corporation during the period specified by the Secretary."

(b)Late Elections.—Subsection (b) of section 1362 is amended by adding at the end thereof the following new paragraph:

"(5) AUTHORITY TO TREAT LATE ELECTIONS AS TIMELY.—If—

"(A) an election under subsection (a) is made for any taxable year (determined without regard to paragraph (3)) after the date prescribed by this subsection for making such election for such taxable year, and

"(B) the Secretary determines that there was reasonable cause for the failure to timely make such election,

the Secretary may treat such election as timely made for such taxable year (and paragraph (3)) shall not apply."

2. Provide for automatic waiver of certain inadvertent terminations.

Current Law: The IRS has the authority to waive the effect of an inadvertent S corporation termination and *may* have authority to *automatically* waive such effect. A high percentage of private letter ruling requests on S corporations deal with the issue of inadvertent terminations.

Problem: For many taxpayers, obtaining a waiver of their terminated S status can result in costly professional fees. Also, valuable time on the part of IRS personnel and tax professionals is lost on processing routine taxpayer waiver requests.

Recommendation: The Group recommends that an automatic waiver procedure be authorized by Congress so that an entity would not lose its S corporation status due

to a terminating event of a "ministerial" nature. An example of such an event is when a beneficiary fails to make a qualified subchapter S trust election.

LEGISLATIVE LANGUAGE: No Legislative language.

FRINGE BENEFITS

1. **Place S corporation shareholders in the same position as owners of regular corporations with respect to fringe benefits.**

Current Law: Unlike a C corporation, an S corporation is not permitted to provide shareholder-employees with certain tax-favored fringe benefits. Instead, the S corporation is treated as a partnership and 2 percent shareholders are treated as partners for fringe benefits purposes. All other shareholder-employees of the S corporation are treated like employees of a regular corporation with respect to fringe benefits.

Problem: S corporations operate at a disadvantage to C corporations with respect to fringe benefits paid to owner/employees. For owners of small businesses this is especially onerous because their fringe benefits are a greater portion of their overall compensation. Furthermore, owners of S corporations (like owners of partnerships and C corporations) are already governed by extensive antidiscrimination rules which makes section 1372 treatment unnecessary.

> Example: All the employees of a small retail store including the owners receive medical and group-term life insurance coverage. As a C corporation, these benefits are tax-free to all employees including the owners. However, if this corporation elects S status, the benefits will be taxable to the owners.

Recommendation: The Group recommends that all S corporation employees be eligible for tax-favored fringe benefits, which would ensure consistent treatment with the employees of a C corporation.

LEGISLATIVE LANGUAGE: No legislative language. [This proposal, if enacted would repeal section 1372 in its entirety.]

2. **Repeal restrictions on qualified plan loans made to S corporation shareholders.**

Current Law: A loan by a corporation's qualified retirement plan to a "disqualified person" is a prohibited transaction, subjecting the borrower to a penalty tax. For C corporations, a disqualified person includes any shareholder who owns ten percent

or more of the corporation's stock. For an S corporation, however, any shareholder who owns *five percent* or more of the corporation's stock is a disqualified person.

Problem: When a C corporation makes an S election, any shareholder who owns between five and ten percent of the qualified retirement plan sponsored by the corporation must repay the loan before the effective date of the S election or face an automatic penalty tax. As a practical matter, very few people are aware that the restrictions on loans from qualified retirement plans are more stringent for an S corporation than for a C corporation. Consequently, five-to-ten-percent shareholders of a C corporation that elects S status may inadvertently find themselves subject to a penalty tax for failing to repay loans from qualified plans before the effective date of the S election.

> Example: A small software development company operates as a C corporation and maintains a qualified pension plan for its employees. An employee, who also owns 6 percent of the corporation's stock, borrows $10,000 from the plan to pay for a family medical emergency. The corporation elects to be an S corporation . The borrower/shareholder is unaware of the more restrictive limitation on plan loans to S corporation shareholder/employees and fails to fully repay the loan before the S election takes effect. He becomes subject to the automatic penalty.

Recommendation: The current more restrictive limitation on S corporation shareholders should be repealed. The definition of a "disqualified person", as including a ten-percent or greater shareholder, should apply uniformly to both C corporations and S corporations.

LEGISLATIVE LANGUAGE: Section 4975(d) would be amended by deleting from the last sentence of the flush language ". . . a shareholder-employee (as defined in section 1379, as in effect on the day before the date of the enactment of the Subchapter S Revision Act of 1982), . . .".

TECHNICAL PROPOSALS

1. Treat losses on liquidation of S corporations as ordinary to the extent the loss created by ordinary income passthrough triggered the liquidation.

Current Law: If an S corporation sells an appreciated asset or distributes it to shareholders, the appreciation in value of the asset is generally taxed once -- at the shareholder level. The gain recognized in such dispositions can be characterized either as capital gain or ordinary income, depending on the asset being sold or distributed. Any recognized gain or income increases the basis of S corporation

shareholders in their stock. If the S corporation liquidates, any loss on liquidation will generally be a capital loss, even if, in the process of liquidation, ordinary income is recognized on assets sold or distributed. In other words, a shareholder can receive a flowthrough of ordinary income and resulting increase in basis as a result of disposition of assets in liquidation. But any loss on the liquidation will generally be capital loss, even if the basis was created by a transaction resulting in ordinary income.

Recommendation: The Group recommends that the loss recognized by a shareholder on the complete liquidation of an S corporation be treated as ordinary rather than capital to the extent the shareholder's basis in the S corporation stock is attributable to ordinary income, that was recognized as a result of the liquidation.

LEGISLATIVE LANGUAGE: ABA proposal to amend § 331(c).

SECTION 331:

Section 331 would be amended by adding the following as section 331(c) and redesignating former section 331(c) as section 331(d):

[Sec. 331(c)]

(c) LIQUIDATIONS OF S CORPORATION. -

(1) That portion of any loss recognized by a shareholder of an S corporation (as defined in section 1361(a)(1)) on amounts received by such shareholder in a distribution in complete liquidation of such S corporation equal to the ordinary income basis of stock of such S corporation in the hands of such shareholder shall not be treated as a loss from the sale or exchange of a capital asset but shall be treated as an ordinary loss.

(2) For purposes of this subsection, "ordinary income basis" of stock of an S corporation in the hands of a shareholders of such S corporation means that portion of such shareholder's basis in such stock equal to the aggregate increases in such basis under section 1367(a)(1] resulting from such shareholder's pro rata share of ordinary income of such S corporation, determined under section 1366.

2. **Allow a carryover of disallowed losses and deductions under section 465 to the post-termination transition period.**

Current Law: Losses of S corporation shareholders suspended by the subchapter S basis rules, may be recognized after the S election terminates and during the post-termination transition period if basis in the S corporation is generated during such period. S corporation losses may also be suspended under the at-risk rules. S corporations and their shareholders are treated in the same fashion as partners in partnerships under the at-risk rules. However, losses suspended through the application of the at-risk rules are *not* carried over to the post-termination transition period for the (former S corporation) entity.

Problem: The post-termination transition period rule allows a last-chance opportunity for S corporation shareholders to establish basis in the corporation and thus use losses that had passed through to them in previous years but that were nondeductible because of a lack of basis at that time. However, in some cases, S corporation shareholders had enough basis to deduct losses, but the losses were suspended under the at-risk rules for which there is no post-terminations transition period opportunity. To provide a last chance opportunity for these losses, it is appropriate to extend current law treatment of losses suspended because of insufficient basis to losses suspended under the at-risk rules.

Recommendation: Losses suspended in the application of the at-risk rules should be permitted to be carried over to the post-termination transition period.

LEGISLATIVE LANGUAGE: No legislative language.

3. **Expand the period of post-death S qualification for certain trusts.**

Current Law: A testamentary trust is permitted to be a shareholder of an S corporation for a period not to exceed 60 days following the death of a deceased S corporation shareholder. There is also a similar 2 year rule for grantor trusts and deemed grantor trusts. After the 60 day period, the trust must transfer ownership of the shares to an eligible S corporation shareholder or (if qualified) become a Qualified Subchapter S Trust. There is a two-year rule for those trusts with corpus included in grantor's estate.

Problem: The requirement that the trust transfer ownership of its S corporation shares within the 60-day period is a significant compliance and administrative burden for many taxpayers. The trustee may be unaware of the need to transfer the S corporation stock until advised to do so by a tax advisor who is involved in the administration of the decedent's estate. Often, this may not occur until more than sixty days following the decedent's death.

Example: The owner of a 20% interest in the stock of an S corporation that operates a farm equipment dealership provided in her will that on her death her stock would pass to a testamentary trust. A family member was named the trustee. The shareholder died on April 15, 1992. Not until February 1993, when family members consulted a tax advisor about preparing 1992 tax returns for the decedent, her estate and the trust did the trustee discover that the S corporation stock should have been transferred out of the trust within 60 days after the shareholder's death. As a result, the corporation's S election terminated on the sixty-first day.

Recommendation: The period of time that the trust may own the S corporation stock be extended to two years. By enacting a two-year period, Congress would be taking positive steps to relieve compliance and inadvertent termination problems.

LEGISLATIVE LANGUAGE: ABA proposal to amend § 1361(c)(2)(a)(ii) and (iii), with ABA's six-month period changed to 2 years plus deletion of the last sentence of (ii). The following language reflects these alterations.

SECTION 1361:

[Sec. 1361(c)(2)]

Section 1361(c)(2)(a)–

(ii) A trust which was described in clause (i) immediately before the death of the deemed owner and which continues in existence after such death, but only for the ~~60-day~~ two-year period on the day of the deemed owner's death. ~~If a trust described in the preceding sentence and if the entire corpus of the trust is includible in the gross estate of the deemed owner, the preceding sentence, shall be applied by substituting '2-year period for '60 day six-month period'.~~

(iii) A trust with respect to stock transferred to it pursuant to the terms of a will, but only for the ~~60-day~~ two-year period beginning on the day on which such stock is transferred to it.

4. Modify order of adjustments to Accumulated Adjustments Account (AAA) and stock basis.

Current Law: Adjustments are made to the basis of an S corporation shareholder's stock in the sequence of income first, losses second, and distributions third. On the

other hand, partnership basis is adjusted first by income, second by distributions, and third by losses.

Recommendation: The Group believes that the subchapter K rules involving the ordering of adjustments to basis should also apply in determining the basis of S corporation stock and the S corporation AAA. Thus, for purposes of subchapter S, distributions under this proposal would be taken into account before losses. (This proposal was included as a measure in H.R. 13.)

LEGISLATIVE LANGUAGE: H.R. 13 § 602.

SEC. 602. TREATMENT OF DISTRIBUTIONS DURING LOSS YEARS.

(a) Adjustments For Distributions Taken Into Account Before Losses.—

(1) Subparagraph (A) of section 1368(d)(1) is amended by striking "paragraph (1)" and inserting "paragraphs (1) and (2)(A)".

(2) Subsection (d) of section 1368 is amended by adding at the end thereof the following new sentence:

"In the case of any distribution made during any taxable year, the adjusted basis of the stock shall be determined with regard to the adjustments provided in paragraph (1) of section 1367(a) for the taxable year."

(b)Accumulated Adjustments Account.—Paragraph (1) of section 1368(e) (relating to accumulated adjustments account) is amended by adding at the end thereof the following new subparagraph:

"(C) NET LOSS FOR YEAR DISREGARDED.—

"(i) In General.—In applying this section to distributions made during any taxable year, the amount in the accumulated adjustments account as of the close of such taxable year shall be determined without regard to any net negative adjustment for such taxable year.

"(ii) Net Negative Adjustment.—For purposes of clause (i), the term 'net negative adjustment' means, with respect to any taxable year, the excess (if any) of—

"(I) the reductions in the account for the taxable year (other than for distributions), over

"(II) the increases in such account for such taxable year."

(c) Conforming Amendments.—Subparagraph (A) of section 1368(e)(1) is amended—

(1) by striking "as provided in subparagraph (B)" and inserting "as otherwise provided in this paragraph", and

(2) by striking "section 1367(b)(2)(A)" and inserting "section 1367(a)(2)".

5. Permit consent dividend for AAA by-pass election.

Current Law: Certain adverse consequences, including termination of the S election caused by excess passive investment income, can accrue to an S corporation which retains earnings and profits from the time it was a C corporation. C corporation earnings and profits can be purged from the corporation by making a shareholder distribution. Normally, such distributions are first made out of AAA. However, an election is available to by-pass AAA and make the distribution out of C corporation earnings and profits. Proposed regulations under section 1368, if finalized, would permit a corporation to elect consent dividend treatment to by-pass the AAA and distribute out its C corporation earnings and profits. (A consent dividend allows the corporation to make a deemed distribution followed by a deemed contribution.)

Problem: Without a consent dividend procedure, distributions must be made with cash or other assets. Frequently, sufficient cash or other assets are not available to make a distribution. A consent dividend procedure solves this problem. But some argue there may not be sufficient administrative authority to provide a consent dividend procedure in the regulations.

Recommendation: The Group supports the consent dividend treatment provision of the proposed regulations and therefore, recommends that this particular provision of the regulations be codified in addition to being included as part of final regulations.

LEGISLATIVE LANGUAGE: ABA proposal to amend §1368(e)(3)(C).

SECTION 1368:

[Sec. 1368 (e)]

(3) ELECTION TO DISTRIBUTE EARNINGS FIRST.–

(C) CONSENT DIVIDEND.–Under regulations prescribed by the Secretary, and to the extent it has accumulated earnings and profits, a corporation may consent to treat as a distribution, subject to the election under this paragraph, the amount specified in such consent. The amount so specified shall be considered as distributed in money by the corporation to its shareholders on the last day of the taxable year of the corporation and as contributed to the capital of the corporation by the shareholders on such day.

6. Permit subchapter C to apply to S corporations.

Current Law: An S corporation in its capacity as a shareholder of another corporation is treated as an individual for purposes of subchapter C. The IRS has taken the position that this prevents the tax-free liquidation of a C corporation into an S corporation under the rationale a C corporation cannot liquidate tax-free when owned by an individual.

Recommendation: The Group recommends repeal of the rule which treats an S corporation in its capacity as a shareholder of another corporation as an individual. Under this recommendation, the liquidation of a C corporation into an S corporation will be governed by the generally applicable subchapter C rules. (This proposal was included as a measure in H.R. 13.)

LEGISLATIVE LANGUAGE: H.R. 13 § 603(a).

> (a) Treatment of S Corporations Under Subchapter C.—Subsection (a) of section 1371 (relating to application of subchapter C rules) is amended to read as follows:
>
> "(a) Application of Subchapter C Rules.—Except as otherwise provided in this title, and except to the extent inconsistent with this subchapter, subchapter C shall apply to an S corporation and its shareholders."

7. Elimination of pre-1983 subchapter S earnings and profits.

Current Law: The accumulated earnings and profits of a corporation are not increased for any year in which an election to be treated as an S corporation is in effect. However, under the subchapter S rules in effect prior to 1983, a corporation electing S status for a taxable year increased its accumulated earnings and profits if its earnings and profits for the year exceeded both its taxable income for the year and its distributions out of that year's earnings and profits. The Subchapter S Revision Act of 1982 repealed this rule for earnings attributable to taxable years beginning after 1982 but did not do so for previously accumulated S corporation earnings and profits.

Recommendation: The Group recommends that a corporation's accumulated earnings and profits be solely attributable to taxable years for which an S election was not in effect. This recommendation involves the elimination of S corporation earnings and profits attributable to periods preceding the effective date of the Subchapter S Revision Act of 1982. (This proposal was included as a measure in H.R. 13.)

LEGISLATIVE LANGUAGE: H.R. 13 § 603(c).

(c) Elimination of Pre-1983 Earnings and Profits.—
(1) In general.—If—
(A) a corporation was an electing small business corporation under subchapter S of chapter 1 of the Internal Revenue Code of 1986 for any taxable year beginning before January 1, 1983, and
(B) such corporation is an S corporation under subchapter S of chapter 1 of such Code for its first taxable year beginning after December 31, 1991,
the amount of such corporation's accumulated earnings and profits (as of the beginning of such first taxable year) shall be reduced by an amount equal to the portion (if any) of such accumulated earnings and profits which were accumulated in any taxable year beginning before January 1, 1983, for which such corporation was an electing small business corporation under such subchapter S.
(2) Conforming Amendments.—
(A) Paragraph (3) of section 1362(d) is amended—
(i) by striking "subchapter C" in the paragraph heading and inserting "accumulated",
(ii) by striking "subchapter C" in subparagraph (A)(i)(I) and inserting "accumulated", and
(iii) by striking subparagraph (B) and redesignating the following subparagraph accordingly.
(B)(i) Subsection (a) of section 1375 is amended by striking "subchapter C" in paragraph (1) and inserting "accumulated".
(ii) Paragraph (3) is section 1375(b) is amended to read as follows:
"(3) PASSIVE INVESTMENT INCOME, ETC.—The terms 'passive investment income' and 'gross receipts' have the same respective meanings as when used in paragraph (3) of section 1362(d)."
(iii) The table of sections for part III of subchapter S of chapter 1 is amended by striking "subchapter C" in the item relating to section 1375 and inserting "accumulated".
(C) Clause (i) of section 1042(c)(4)(A is amended by striking 'section 1362(d)(3)(D)' and inserting 'section 1362(d)(3)(C)'.

8. Simplify the procedures for electing to close the books on the termination of a shareholder's interest.

Current Law: A corporation may elect to close its books at the date of complete termination of a shareholder's interest. All shareholders (including persons who were taxpayers at any time during the year) must give their consent to this election. This requirement imposes compliance burdens in the preparation and filing of timely

corporate tax returns. According to the holding in an IRS private letter ruling, even if a corporation does not have the consensus of unaffected shareholders, it still may be in "substantial compliance" with the tax law when the allocations were prepared correctly.

Problem: Under current law, all shareholders of the corporation must consent to this election, including those that are unaffected. The necessity of obtaining the signatures of these unaffected shareholders imposes an unreasonable administrative burden, especially when the corporation is owned by multiple shareholders. Rather, the election should only be made by those affected shareholders, that is, those who were involved in a stock transaction during the year.

> Example: A small manufacturing business is owned by 24 shareholders. During the year, one of the shareholders sells her stock to an outsider. Because income is not earned ratably throughout the year, the parties decide that they wish to close the books at the date of sale, rather than allocate income as if it were earned ratably throughout the year. This election only acts to allocate income between the buyer and seller. It has no impact on the other 23 shareholders. Under current law, this consent must be obtained from all 24 shareholders no matter how small their stockholdings. This can unfairly hold the election hostage to shareholders who are unaffected by the election.

Recommendation: Instead of having to obtain the consent of all shareholders, the Group recommends that the closing of a corporation's books be permitted if both the affected shareholders and corporation consent.

LEGISLATIVE LANGUAGE: ABA proposal to amend § 1377(a)(2). [Shaded language indicates a change to the ABA draft needed to conform it to the Working Groups' proposal.]

SECTION 1377:

[Sec. 1377(a)]

(a) PRO RATA SHARE.–For purposes of this subchapter–

* * * *

(2) ELECTION TO TERMINATE YEAR.–

(A) IN GENERAL.–Under regulations prescribed by the Secretary, if any shareholder terminates his interest in the corporation during the taxable year and all ~~persons who are shareholders during the taxable year~~ affected shareholders and the corporation agree to the application of this

paragraph, paragraph (1) shall be applied to the affected shareholders as if the taxable year consisted of 2 taxable years the first of which ends on the date of the termination.

(B) AFFECTED SHAREHOLDERS.--For purposes of subparagraph (A), the term 'affected shareholders' means the shareholder whose interest is terminated and all shareholders to whom he has transferred shares during the taxable year. If he has transferred shares to the corporation, 'affected shareholders' shall include all persons who are shareholders during the taxable year.

9. Expand the post-termination transition period.

Current Law: If an entity loses its S corporation status, it may distribute cash to shareholders during the post-termination transition period. The distribution is then applied against the adjusted basis of the stock. The shareholder receives the cash tax free to the extent the amount distributed does not exceed the Accumulated Adjustments Account (AAA). If there is excess, it is treated as capital gain. Also, the AAA ceases to exist for tax purposes at the end of the post-termination transition period. Distributions made after the post-termination transition period are taxed under the regular Subchapter C provisions.

Problem: Because of the large number of occurrences that can terminate a corporation's S election, an S corporation and its shareholders may be unaware of a termination until an IRS examination in a subsequent year brings the facts to light. In such situations where inadvertent termination relief may not be available, the period within which to make post-termination distributions may already have elapsed.

Example: A shareholder of an S corporation irrevocably transferred stock to a trust that he believed in good faith to be an eligible S corporation shareholder. Two years later, an IRS examination determined that the trust was not eligible. Under the terms of the trust agreement, the stock cannot be transferred out of the trust. Accordingly, inadvertent termination relief is unavailable. Since the post-termination transition period has elapsed, the corporation is unable to make a tax-free distribution of its AAA.

Recommendation: The group recommends a broadening of the definition of post-termination transition period with respect to the 120 day period following a determination that the corporation's election had terminated for a previous taxable year.

LEGISLATIVE LANGUAGE: ABA proposal to amend § 1377(b)(1)(C).

SECTION 1377:

[Sec. 1377(b)]

(b) POST-TERMINATION TRANSITION PERIOD.–

(1) IN GENERAL.–For purposes of this subchapter, the term 'post-termination transition period' means–

(A) the period beginning on the day after the last day of the corporation's last taxable year as an S corporation and ending on the later of–

(i) the day which is 1 year after such last day, or

(ii) the due date for filing the return for such last year as an S corporation (including extensions), ~~and~~

(B) the 120-day period beginning on the date of a determination that the corporation's election under section 1362(a) had terminated for a previous taxable year, and

(C) the 120-day period beginning on the date of a determination (following the termination of the corporation's election) that adjusts an item of income (other than tax-exempt income), loss or deduction arising during the S period, but only if the determination arises in a corporate-level audit proceeding under sections 6241 through 6245 or in an audit proceeding with respect to a person who was the sole shareholder of the corporation at all times during each taxable year of the S period for which such adjustment has been made.

(2) DETERMINATION DEFINED.–For purposes, of paragraph (1), the term determination means–

(A) a determination as defined in section 1313(a).

~~(A)~~ (B) a court decision which becomes final,

~~(B)~~ (C) a closing agreement, or

~~(C)~~ (D) an agreement between the corporation and the Secretary that the corporation failed to qualify as an S corporation.

Mr. HOAGLAND. Mr. Padwe from the American Institute of Certified Public Accountants.

STATEMENT OF GERALD W. PADWE, VICE PRESIDENT OF TAXATION, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

Mr. PADWE. Thank you, Mr. Chairman. I am Gerald Padwe, vice president of taxation of the AICPA; and I am accompanied here this afternoon by the chairman of the AICPA S Corporation Tax Committee, Mr. Samuel Starr, sitting behind me, who has spent literally hundreds of hours over the past 13 months helping with the proposals which I wish to speak with you about today.

Despite the challenge of a 3-minute time limit, let me take a couple of seconds of that, please, to especially thank Congressman Cardin for proposing these amendments to subchapter S for your subcommittee's consideration, as well as to Congressman Payne for his very, very strong interest in reforming the S corporation parts of the Internal Revenue Code.

S corporations became particularly popular in 1982 after a multiyear collegial effort which even preceded the effort that Mr. Rose has just described in the early 1990s, which was on the part of the AICPA, the American Bar Association Section on Taxation, and the staff of the Joint Committee on Taxation. At that time, for the first time since its enactment in 1958, the S corporation rules really were updated to try and bring them a little more closely into alignment with business realities.

I should say that, in part, as a result of that effort, today over 1.5 million small businesses—42 percent, 42 percent of corporate tax return filers are S corporations. We believe that the tax system and the small business community both have been beneficiaries of those early 1980s efforts.

We come to you now, 11 years after, asking one more time that you modernize subchapter S to enable those corporations to operate more on a par with partnerships and C corporations—which are corporations without an S election in effect. Our colleagues in this effort include the U.S. Chamber of Commerce, again, the Section of Taxation of the American Bar Association, and several other organizations that have indicated their strong support of our efforts, including the National Federation of Independent Business, the National Association of Private Enterprise, and the Small Business Legislative Council.

You referred, sir, to the Treasury Department comments this morning, and getting their second lowest ranking. I looked at the written statement that they submitted and, actually, I find them somewhat more encouraging than that ranking might indicate. What they say is that they agree it is time to relook at subchapter S and, indeed, to modernize the statute and bring it into the 1990s. That is exactly what we believe.

Small business does not operate in the 1990s the way it did in the 1950s, and some of those 1950s constraints in the statute are handicapping what these businesses are able to do. Times, and financial transactions, were much simpler then. subchapter S requires a fresh, 1990s outlook.

The proposal to amend subchapter S, which we discuss today, contains 26 separate recommendations. A number of them were contained either in H.R. 13, the Tax Simplification Act of 1993, which was introduced early this year by Chairman Rostenkowski, and/or in last year's H.R. 11, which was passed by the entire Congress, but which was not ultimately enacted. The package of recommendations as a whole, the consensus package, would modernize this area of the Code by accomplishing four broad goals. I just want to mention them; I will not discuss them at length: reform of S corporation fringe benefit rules; expansion of capital formation techniques available to S corporations, which is very important in today's world; preservation of family-owned businesses; and as Mr. Rose has said, removal of undesirable tax traps.

We have submitted detailed comments in our written testimony which include precise statements of the problems that we are trying to correct with these recommendations. Mr. Starr or I would be more than delighted to discuss any of them with you. We share the views of the American Bar Association Tax Section, and we are delighted to present our views to you today as well.

Thank you, sir.

Mr. HOAGLAND. Thank you.

[The prepared statement follows:]

STATEMENT OF GERALD W. PADWE,
AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

INTRODUCTION

Good morning. I am Gerald W. Padwe, Vice President—Taxation of the 320,000-member American Institute of Certified Public Accountants. Accompanying me today is the chairman of the AICPA S Corporation Taxation Committee, Mr. Samuel P. Starr.

We thank you for the opportunity to testify on a tax issue of high priority for the AICPA, the reform of Subchapter S. We especially want to thank Representative Cardin for proposing these suggested amendments to subchapter S for the consideration of this subcommittee. We further want to recognize Representative Payne for the interest he has shown in our effort to modernize this area of the Internal Revenue Code.

Subchapter S was first enacted in 1958 to help remove tax considerations from small business owners' decisions to incorporate. Electing "subchapter S corporations" (as they were then called) were not subject to the classic two-tier tax system, applicable to nonelecting corporations. This tax treatment was helpful to small business and especially to start-up businesses. But subchapter S, as originally enacted, was very limiting and contained a number of pitfalls and traps for the unwary.

It was not until 1982 that subchapter S became popular. In that year, after a multi-year, collegial effort on the part of the AICPA, members of the American Bar Association's Section of Taxation, and the staff of the Joint Committee on Taxation, subchapter S was substantially revised to remove many of its traps and some of its obsolete restrictions. Subsequently, changes made in the *Tax Reform Act of 1986* made the election of subchapter S treatment highly desirable to many small businesses. Today, over 1.5 million small businesses, 42 percent of corporate tax return filers, are S corporations.[1] In short, the tax system and the small business community have both been beneficiaries of these efforts.

We come to you now, eleven years after the enactment of the *Subchapter S Revision Act of 1982*, asking that you modernize subchapter S to enable S corporations to operate more on a par with partnerships and C corporations (those corporations without a subchapter S election in effect). Our colleagues in this effort include the U.S. Chamber of Commerce and, again, members of the American Bar Association's Section of Taxation. In addition, a number of other organizations have been supportive of our efforts to modernize subchapter S, including the National Federation of Independent Business, the National Association of Private Enterprise, and the Small Business Legislative Council.

We believe subchapter S should be amended to better reflect the way small business does business in the '90s. Many of the prohibitive restraints currently in subchapter S date back to its original enactment in 1958. The financial environment in the 1990's is far more complex, and 1950's legislative restraints are handicapping small business. A 90's small business does not operate the way a 50's small business did. Times (and financial transactions) were simpler then. Subchapter S requires a fresh 90's outlook.

For instance, with the traditional sources of debt financing—commercial banks—presently restricting their loans to small business, these businesses have had to turn to nontraditional sources of financing such as venture capitalists and pension funds. Typically, these sources of financing want either an equity stake in the business or, at a minimum, debt that can be converted into equity interests. A small business operating as a partnership or C corporation can offer these benefits to a financier and thereby utilize these sources of capital. An S corporation cannot offer a similar set of inducements to financiers. Restrictions in subchapter S limit or outright preclude tapping these sources of financing.

The proposal to amend subchapter S which we are discussing today contains twenty-six separate recommendations. A number are contained in H.R.13, the *Tax Simplification Act of 1993*, which was introduced earlier this year by Chairman Rostenkowski. The package of recommendations, taken as a whole, would modernize this area of the Internal Revenue Code by accomplishing four broad goals:

- Reform of S corporation fringe benefit rules,
- Expansion of the capital formation techniques available to S corporations,

- Preservation of family-owned businesses, and
- Removal of undesirable tax traps.

REFORM S CORPORATION FRINGE BENEFIT TREATMENT

Place S corporation shareholders in the same position as owners of regular corporations with respect to fringe benefits. *Pamphlet,[2] section D.4.g.*

Under current law, an S corporation, unlike a C corporation, is not permitted to provide shareholder-employees with certain tax-favored fringe benefits. Instead, for fringe benefits purposes, the S corporation is treated as a partnership and 2-percent shareholders are treated as partners. All other shareholder-employees of the S corporation are treated like employees of a regular corporation with respect to fringe benefits.

The problem here is that S corporations operate at a disadvantage to C corporations with respect to fringe benefits paid to owner/employees. For owners of small businesses this is especially onerous because their fringe benefits are a greater portion of their overall compensation. Furthermore, owners of S corporations (like owners of partnerships and C corporations) are already governed by extensive antidiscrimination rules which make section 1372 treatment unnecessary.

> Example: All the employees of a small retail store (including the owners) receive medical and group-term life insurance coverage. As a C corporation, these benefits are tax-free to all employees including the owners. However, if this corporation elects S status, the benefits will be taxable to the owners.

To solve this problem, we recommend you repeal Code section 1372.

Repeal restrictions on qualified plan loans made to S corporation shareholders. *Pamphlet, section D.4.g.*

Under current law, a loan by a corporation's qualified retirement plan to a "disqualified person" is a prohibited transaction, subjecting the borrower to a penalty tax. For C corporations, a disqualified person includes any shareholder who owns ten percent or more of the corporation's stock. For an S corporation, however, any shareholder who owns *five percent* or more of the corporation's stock is a disqualified person.

The problem here is that when a C corporation makes an S election, any shareholder who owns between five and ten percent of the qualified retirement plan's corporate sponsor corporation must repay the loan before the effective date of the S election or face an automatic penalty tax. As a practical matter, very few people are aware that the restrictions on loans from qualified retirement plans are more stringent for an S corporation than for a C corporation. Consequently, five-to-ten-percent shareholders of a C corporation that elects S status may inadvertently find themselves subject to a penalty tax for failing to repay loans from qualified plans before the effective date of the S election.

> Example: A small software development company operates as a C corporation and maintains a qualified pension plan for its employees. An employee who also owns 6 percent of the corporation's stock borrows $10,000 from the plan to pay for a family medical emergency. The corporation elects to be an S corporation. The borrower/shareholder is unaware of the more restrictive limitation on plan loans to S corporation shareholder/employees and fails to fully repay the loan before the S election takes effect. She becomes subject to the automatic penalty.

We view this as a trap for the unwary, and recommend hat the current, more restrictive limitation on S corporation shareholders be repealed. The definition of a "disqualified person", as including a ten-percent-or-greater shareholder, should apply uniformly to both C corporations and S corporations.

ACCELERATE CAPITAL FORMATION

Increase the thirty-five-shareholder limitation to fifty shareholders. *Pamphlet, section D.4.a.1.*

Under current law, an S corporation election is not valid if the business has more than 35 shareholders. This presents a problem for multi-generational, family-held businesses. This highly artificial limit on the number of shareholders prevents a corporation from continuing to operate as an S corporation as the number of shareholding generations increases. Also, some high-tech corporations that want to reward key employees are artificially limited to a thirty-five shareholder limitation.

> Example: A furniture manufacturing company now owned by the second and third generations of the two founding families is an S corporation. Currently they have 25 shareholders. Mathematically, the S corporation status will not be able to continue into the next generation.

We recommend the current S corporation limit of 35 shareholders, which serves to restrict capital formation opportunities of smaller firms, be raised to 50 shareholders.[3]

Permit certain tax-exempt organizations to be eligible shareholders. *Pamphlet, section D.4.a.2.*

Under current law, a tax-exempt organization is not an eligible shareholder for purposes of a valid S corporation election. This presents a problem because tax-exempt organizations including pension plans, ESOPs (a qualified employee stock ownership plan), and university endowment funds are significant sources of capital for small closely-held businesses seeking to expand their operations. Because tax-exempt organizations are ineligible shareholders, these sources of capital are unavailable to S corporations, again placing them at a competitive disadvantages to C corporations.

> Example: The founder of an S corporation wants to retire and would like to sell the business to its employees. To obtain the financing required for an employee purchase, a C corporations would normally establish an ESOP. However, this S corporation owner will likely be forced to sell to outside interests and not to the employees because an ESOP is an ineligible shareholder.

We recommend tax-exempt organizations become eligible to hold stock in S corporations. This proposal would allow the partnership flow-through approach to be used with exempt organization shareholders of an S corporation. For example, any trade or business income allocable to the exempt organization shareholder would be subject to the unrelated business income tax, or UBIT, but interest and dividend income would not.

Allow nonresident alien shareholders to own S corporation stock. *Pamphlet, section D.4.a.3.*

Under current law, a nonresident alien is not an eligible shareholder for purposes of a valid S corporation election. This presents a problem for S corporations, because frequently, sources of capital or entre to foreign markets require an equity participation by a nonresident alien.

> Example: A local S corporation manufacturer has an opportunity to expand sales into the European market. A European individual who will manage oversees marketing wants to invest in a minority equity position in the company. The restriction on ownership of S corporation stock by nonresident alien shareholders forces the manufacturer to either give up its S corporation status or resort to unnecessarily sophisticated and expensive tax planning techniques.

We recommend that nonresident aliens (individuals only) be treated as eligible shareholders. Under this recommendation, any effectively connected U.S. income allocable to the nonresident alien should be subject to a withholding tax similar to the tax imposed on nonresident partners of a partnership.

Permit S corporations to issue preferred stock. *Pamphlet, section D.4.b.1.*

Under current law, an S corporation is permitted to have only one class of stock. This presents a serious problem for S corporations seeking venture capital, because venture capitalists and other outside sources of funding generally require an equity position that provides a preferred return with the upside potential for capital gain to enhance the rate of return on investment.

> Example: A small S corporation has developed a promising new product. To bring it to market, it requires outside investment capital. With family and commercial bank sources of capital exhausted, it now seeks venture capital. As an S corporation, it is precluded from offering venture capitalists an economically attractive investment opportunity.

We recommend that S corporations be permitted to issue preferred stock, including convertible preferred stock. Under this proposal, only eligible S corporation shareholders would be allowed to own preferred stock.

Permit an S corporation to own more than 80 percent of a C corporation's stock. *Pamphlet, section D.4.c.*

Under current law, an S corporation may own as much as 79 percent of the stock of another corporation without jeopardizing the S election. Yet, for valid, nontax business reasons, corporations frequently establish subsidiaries to hold their different business activities. Normally, these would be wholly-owned subsidiaries. An S corporation is precluded from using this ownership structure because of the prohibition on affiliated companies. Currently, this business goal can only be accomplished by using inefficient and costly tax planning techniques.

> Example: A local general construction company, organized as an S corporation, has developed expertise in asbestos abatement and removal. However, concerns about potential liability exposure may cause the corporation to withdraw from this business, unless it can be dropped into a subsidiary.

We recommend that a corporation be permitted to elect S status regardless of the percentage of stock it owns in a C corporation subsidiary. However, we also recommend that no S corporation be permitted to participate in any consolidated returns.[4]

Permit S corporations to own S corporation stock. *Pamphlet, section D.4.c.*

Under current law, S corporations are not permitted to have corporate shareholders. While the preceding proposal would allow wholly-owned subsidiaries, those subsidiaries would be denied flowthrough treatment. (The subsidiary could not itself be an S corporation because S corporations cannot have corporations as shareholders.) This defeats the objective of subchapter S in permitting flowthrough treatment for the entire business.

In the preceding example, the asbestos subsidiary, if organized, would be restricted to C corporation status. It is inappropriate to deny flowthrough treatment where business reasons necessitate the use of a subsidiary. To obtain flowthrough treatment under current law, the owners of the construction company could form a new "sister" corporation to engage in the asbestos removal business. This alternative is an unnecessarily inefficient and costly corporate structure.

We recommend that an S corporation be permitted to own 100 percent of the stock of another S corporation, as well as a chain of S corporations. The corporate group should not, however, be permitted to file consolidated returns.

Expand "safe harbor straight debt" to permit convertible debt. *Pamphlet, section D.4.b.2.*

Under current law, it is possible that debt may be recharacterized as a second class of stock. However, an obligation that qualifies as "straight debt" is not considered a second class of stock and, thus, does not trigger a termination of the S election. For example, if the

debt contains conversion and liquidation rights, which "straight debt" is not permitted to contain, the entity's S election could be in jeopardy.

The problem this presents is that in today's business world debt instruments frequently contain convertibility features. Under current law, S corporations are at risk that this convertible debt could be construed as a "second class of stock" which would terminate S status. This common debt feature should not terminate S status. While current regulations offer some flexibility, these rules do not adequately resolve this problem.

We recommend, therefore, that the "straight debt" safe harbor provisions be expanded to allow the issuance of convertible debt. However, the debt instrument in question should be required to continue to meet all of the other criteria of straight debt.

Expand "safe harbor straight debt" to permit ineligible shareholders to hold the debt. *Pamphlet, section D.4.b.3.*

Under current tax law, "straight debt." may only be owned by an individual, an estate, or a trust which is eligible to be an S corporation shareholder. This presents a problem because loans from financial institutions and other arms-length borrowing would not be treated as safe harbored straight debt.

To expand financing opportunities for S corporations, we recommend the definition of straight debt be expanded so that loans from financial institutions and other lenders not be subjected to greater restrictions than loans made by others.

PRESERVE FAMILY-OWNED BUSINESSES

Expand trusts permitted to own S corporation stock to include those with multiple income beneficiaries, the ability to accumulate trust income, and trustee powers to spray income among the beneficiaries. *Pamphlet, section D.4.a.4.*

Under current law, only certain types of trusts are permitted to become shareholders of an S corporation, the two most common types of eligible trust shareholders including the grantor trust and the "qualified subchapter S trust" (QSST). The problem this presents for S corporation owners is that the most common trusts used for estate planning purposes have multiple beneficiaries and sprinkling powers vested in the trustee. These trusts are not allowed to hold S corporation stock. As a result, S corporation shareholders do not have access to the same estate planning techniques available to C corporation owners.

> Example: An S corporation owner has an ailing spouse and several children. To properly provide for the family at the owner's death, the owner will probably want to use a trust that allows the trustee to make distributions to care for the medical needs of the ailing spouse and the varying educational needs of the children. To accomplish this, the owner will need to terminate S corporation status or result to unnecessarily complicated and expensive estate planning techniques.

We recommend expansion of the definition of what constitutes a QSST. Under this expanded definition, single-tier trusts would be permitted to have multiple-income beneficiaries and to accumulate income from the S corporation at the trust level. Sprinkle trusts would be treated as eligible S corporation shareholders. Multiple beneficiaries would each, along with the trust, be counted as shareholders. However, the family attribution rules would apply in counting the number of shareholders.

Count all members of a single family who own an S corporation's stock as a single shareholder. *Pamphlet, section D.4.a.5.*

Under current law, only a husband and wife are treated as one shareholder for purposes of the S corporation election. All other members of a family are treated as separate shareholders. For multi-generational, family-held businesses, an artificial limit on the number of shareholders prevents corporations from continuing to operate as an S corporation for future generations.

Example: A furniture manufacturing company now owned by the second and third generations of the two founding families is an S corporation. Currently they have 25 shareholders. Mathematically, the S corporation status will not be able to be continued into the next generation. Under this proposal, solely for purposes of the 35-shareholder limitation, the corporation would be treated as having only two shareholders. For all other purposes, all actual shareholders would be treated as shareholders.

We recommend the family attribution rules under Code section 267(c)(4) apply in the situation of the S corporation election. This means that all family members would be treated as one S corporation shareholder, in determining the if the current thirty-five (for our recommended fifty) shareholder limit is exceeded.

REMOVE UNDESIRABLE TAX TRAPS

Permit shareholder personal guarantees of corporate debt to increase shareholder basis. *Pamphlet, section D.4.d.*

Under current tax law, a partner includes his or her share of partnership indebtedness in his or her basis (in the partnership) for loss deduction purposes. In contrast, an S corporation shareholder is not permitted to include indebtedness of the S corporation in his stock basis, even to the extent the shareholder has provided a personal guarantee of the corporate debt.

Current law emphasizes form over substance. When an S corporation needs additional funds, typically a commercial bank will make the loan directly to the corporation with the additional security of a shareholder guarantee. A well-advised S corporation owner would structure the financing arrangement so that the bank would make the loan to the shareholder who would then reloan the borrowed funds to the corporation. In both cases, the shareholder is economically exposed to repay the loan to the bank. Yet, basis is available only if the shareholder is well-advised before the loan is made.

Example: An S corporation nursery and landscaping business needs additional funds for expansion. The corporation borrows from a bank and the owner personally guarantees the debt. The guarantee does not increase the owner's basis. If the owner had first incurred the expense of consulting a tax advisor, the advisor would have recommended using "back-to-back" loans, which could have resulted in basis to the shareholder without any economic difference to any party—except for the fee paid to the tax advisor.

We recommend that to the extent an S corporation shareholder personally guarantees indebtedness of the S corporation, the shareholder should be permitted to reflect the personal guarantee as part of basis in the entity for loss deduction purposes. To minimize the complexity of this proposal, we recommend that the guarantees available for this treatment be limited to those which have a single guarantor and specifically state the amount guaranteed.

Permit the Secretary of Treasury to treat invalid elections as effective. *Not included in Pamphlet.*

Under current law, the IRS has the authority to waive the effect of an inadvertent S corporation termination, but not the authority to waive the effect of an invalid election caused by an inadvertent failure to qualify as an S corporation.

We believe the IRS should have the authority to waive an inadvertent invalid S corporation election for entities that have subsequently cured the defect. This new authority would be a broadening of the current IRS authority to waive the effect of an inadvertent S corporation termination.[4]

Provide for automatic waiver of certain inadvertent terminations. *Pamphlet, section D.4.f.*

Under current law, the IRS has the authority to waive the effect of an inadvertent S corporation termination and *may* have authority to *automatically* waive such effect. A high

percentage of private letter ruling requests on S corporations deal with the issue of inadvertent terminations. For many taxpayers, obtaining a waiver of their terminated S status can result in costly professional fees. Also, valuable time on the part of IRS personnel and tax professionals is lost on processing routine taxpayer waiver requests.

We recommend an automatic waiver procedure be authorized by Congress so that an entity would not lose its S corporation status due to a terminating event of a "ministerial" nature. An example of such an event is when a beneficiary fails to make a qualified subchapter S trust election.

Repeal excessive passive investment income as a termination event. *Pamphlet, section D.4.e.*

Under current law, subchapter S contains two disincentives to discourage "incorporated pocketbooks" from operating as S corporations. First a corporate-level tax is imposed on excess passive investment income. Second, S status is terminated if the corporation earns passive investment income that exceeds 25 percent of the entity's gross receipts for three consecutive taxable years and the entity has accumulated Subchapter C earnings and profits at the end of each of the three years.

While this result may be avoided through proper tax planning, many unadvised S corporations are caught unaware of these traps and lose their S status. The sanction of terminating S status when the entity has excessive passive income is unduly harsh.

> Example: Due to business fluctuations, the operating business of an S corporation declines over a period of several years. During the recession, a substantial portion of the corporation's income is derived from passive sources. Without proper advice, this corporation may not realize that its S status will terminate if this situation continues for three years.

To the extent Congressional intent is to limit the passive income of an S corporation, we believe this legislative intent is sufficiently served through the current procedures of imposing a corporate-level tax on the S corporation's passive income. Therefore, the sanction of terminating the S election in the situation of excessive passive income should be repealed.

Exclude trade or business income from the passive investment income definition. *Pamphlet, section D.4.e.*

Under current law, the definition of passive investment income for S corporation purposes includes the types of income earned by a personal holding company, and many traditional types of active trade or business income earned by an operating company. By including certain types of active trade or business income in the passive investment income definition, many operating companies are precluded from making the S election.

> Examples: Examples of such operating companies include certain rental real estate operators and certain corporations earning royalty income from the franchising of a product, process, or service.

We recommend the income earned from the active conduct of a trade or business not be included in the S corporation definition of passive income. Instead, a facts and circumstances test should be adopted to determine what constitutes active as opposed to passive income. Examples of regulations that may be used in drafting a facts and circumstances test include Regulation sections 1.355-3(b) and 1.469-2T(c)(3)(i).

TECHNICAL PROPOSALS

Treat losses on liquidation of S corporations as ordinary to the extent the loss created by ordinary income passthrough triggered the liquidation. *Pamphlet, section D.4.h.*

Under current law, if an S corporation sells an appreciated asset or distributes it to shareholders, the appreciation in value of the asset is generally taxed once—at the shareholder level. The gain recognized in such dispositions can be characterized either as capital gain or ordinary income, depending on the asset being sold or distributed. Any

recognized gain or income increases the basis of S corporation shareholders in their stock. If the S corporation liquidates, any loss on liquidation will generally be a capital loss, even if, in the process of liquidation, ordinary income is recognized on assets sold or distributed. In other words, a shareholder can receive a flowthrough of ordinary income and resulting increase in basis as a result of disposition of assets in liquidation. But any loss on the liquidation will generally be capital loss, even if the basis was created by a transaction resulting in ordinary income.

We recommend that the loss recognized by a shareholder on the complete liquidation of an S corporation be treated as ordinary rather than capital to the extent the shareholder's basis in the S corporation stock is attributable to ordinary income, that was recognized as a result of the liquidation.

Allow a carryover of disallowed losses and deductions under section 465 to the post-termination transition period. *Pamphlet, section D.4.i.*

Under current law, losses of S corporation shareholders suspended by the subchapter S basis rules, may be recognized after the S election terminates and during the post-termination transition period if additional basis in the S corporation is generated during such period. S corporation losses may also be suspended under the at-risk rules. S corporations and their shareholders are treated in the same fashion as partners in partnerships under the at-risk rules. However, losses suspended through the application of the at-risk rules are *not* carried over to the post-termination transition period for the (former S corporation) entity.

The post-termination transition period rule allows a last-chance opportunity for S corporation shareholders to establish basis in the corporation and thus use losses that had passed through to them in previous years but that were nondeductible because of a lack of basis at that time. However, in some cases, S corporation shareholders have had enough basis to deduct losses, but the losses were suspended under the at-risk rules for which there is no post-terminations transition period opportunity. To provide a last chance opportunity for these losses, it is appropriate to extend current law treatment of losses suspended because of insufficient basis to losses suspended under the at-risk rules.

We recommend losses suspended in the application of the at-risk rules be permitted to be carried over to the post-termination transition period.

Expand the period of post-death S qualification for certain trusts. *Pamphlet, section D.4.j.*

Under current law, a testamentary trust is permitted to be a shareholder of an S corporation for a period not to exceed 60 days following the death of a deceased S corporation shareholder. There is also a similar 2 year rule for grantor trusts and deemed grantor trusts. After the 60-day period, the trust must transfer ownership of the shares to an eligible S corporation shareholder or (if qualified) become a Qualified Subchapter S Trust. There is a two-year rule for those trusts with corpus included in grantor's estate.

The requirement that the trust transfer ownership of its S corporation shares within the 60-day period is a significant compliance and administrative burden for many taxpayers. The trustee may be unaware of the need to transfer the S corporation stock until advised to do so by a tax advisor who is involved in the administration of the decedent's estate. Often, this may not occur until more than sixty days following the decedent's death.

> Example: The owner of a 20% interest in the stock of an S corporation that operates a farm equipment dealership provided in her will that on her death her stock would pass to a testamentary trust. A family member was named the trustee. The shareholder died on April 15, 1992. Not until August, 1992, when the estate's executor began detailed work on information for the estate tax return did the trustee discover that the S corporation stock should have been transferred out of the trust within 60 days after the shareholder's death. As a result, the corporation's S election terminated on the sixty-first day.

The period of time that the trust may own the S corporation stock should be extended to two years (the same as for grantor trusts). By enacting a two-year period,

Congress would be taking positive steps to relieve compliance and inadvertent termination problems.

Modify order of adjustments to Accumulated Adjustments Account (AAA) and stock basis. *Pamphlet, section D.4.k.*

Under current law, adjustments are made to the basis of an S corporation shareholder's stock in the sequence of income first, losses second, and distributions third. On the other hand, partnership basis is adjusted first by income, second by distributions, and third by losses.

We believe the subchapter K rules involving the ordering of adjustments to basis should also apply in determining the basis of S corporation stock and the S corporation AAA. Thus, for purposes of subchapter S, distributions under this proposal would be taken into account before losses.[4]

Permit consent dividend for AAA by-pass election. *Not included in Pamphlet.*

Under current law, certain adverse consequences, including termination of the S election caused by excess passive investment income, can accrue to an S corporation which retains earnings and profits from the time it was a C corporation. C corporation earnings and profits can be purged from the corporation by making a shareholder distribution. Normally, such distributions are first made out of AAA. However, an election is available to by-pass AAA and make the distribution out of C corporation earnings and profits. Proposed regulations under section 1368, if finalized, would permit a corporation to elect consent dividend treatment to by-pass the AAA and distribute out its C corporation earnings and profits. (A consent dividend allows the corporation to make a deemed distribution to shareholders followed by a deemed contribution by those shareholders back to the corporation.)

Without a consent dividend procedure, distributions must be made with cash or other assets which, frequently, are not available at the appropriate time to make a distribution. A consent dividend procedure solves this problem. But some argue there may not be sufficient administrative authority to provide a consent dividend procedure in the regulations.

We support the consent dividend treatment provision of the proposed regulations and, therefore, recommend this particular provision of the regulations be codified.

Permit subchapter C to apply to S corporations in certain circumstances. *Not included in Pamphlet.*

Under current law, an S corporation in its capacity as a shareholder of another corporation is treated as an individual for purposes of subchapter C. The IRS has taken the position that this prevents the tax-free liquidation of a C corporation into an S corporation under the rationale a C corporation cannot liquidate tax-free when owned by an individual. Recently, the Service has indicated that it may be changing this position,[5] but we believe this latter position should be codified.

We recommend repeal of the rule which treats an S corporation in its capacity as a shareholder of another corporation as an individual. Under this recommendation, the liquidation of a C corporation into an S corporation will be governed by the generally applicable subchapter C rules.[4]

Elimination of pre-1983 subchapter S earnings and profits. *Not included in Pamphlet.*

Under current law, the accumulated earnings and profits of a corporation are not increased for any year in which an election to be treated as an S corporation is in effect. However, under the subchapter S rules in effect prior to 1983, a corporation electing S status for a taxable year increased its accumulated earnings and profits if, for the year, they exceeded both taxable income and distributions out of that year's earnings and profits. The Subchapter S Revision Act of 1982 repealed this rule for earnings attributable to taxable years beginning after 1982 but did not do so for previously accumulated S corporation earnings and profits.

We recommend that a corporation's accumulated earnings and profits be solely attributable to taxable years for which an S election was not in effect. This recommendation involves the elimination of S corporation earnings and profits attributable to periods preceding the effective date of the Subchapter S Revision Act of 1982.[4]

Simplify the procedures for electing to close the books on the termination of a shareholder's interest. *Pamphlet, section D.4.l.*

Under current law, a corporation may elect to close its books at the date of complete termination of a shareholder's interest. All shareholders (including those who held shares at any time during the year) must give their consent to this election. This requirement imposes compliance burdens in the preparation and filing of timely corporate tax returns. According to the holding in an IRS private letter ruling, even if a corporation does not have the consensus of unaffected shareholders, it still may be in "substantial compliance" with the tax law when the allocations were prepared correctly.

Under current law, all shareholders of the corporation must consent to this election, including those that are unaffected. The necessity of obtaining the signatures of these unaffected shareholders imposes an unreasonable administrative burden, especially when the corporation is owned by multiple shareholders. Rather, the election should only be made by those affected shareholders, that is, those who were involved in a stock transaction during the year.

> Example: A small manufacturing business is owned by 24 shareholders. During the year, one of the shareholders sells her stock to an outsider. Because income is not earned ratably throughout the year, the parties decide that they wish to close the books at the date of sale, rather than allocate income as if it were earned ratably throughout the year. This election acts only to allocate income between the buyer and seller. It has no impact on the other 23 shareholders. Under current law, this consent must be obtained from all 24 shareholders no matter how small their stockholdings. This can unfairly hold the election hostage to shareholders who are unaffected by the election.

Instead of having to obtain the consent of all shareholders, we recommend the closing of a corporation's books be permitted if both the affected shareholders and corporation consent.

Expand the post-termination transition period. *Pamphlet, section D.4.m.*

Under current law, if an entity loses its S corporation status, it may distribute cash to shareholders during the post-termination transition period. The distribution is then applied against the adjusted basis of the stock. The shareholder receives the cash tax free to the extent the amount distributed does not exceed the Accumulated Adjustments Account (AAA). If there is excess, it is treated as capital gain. Also, the AAA ceases to exist for tax purposes at the end of the post-termination transition period. Distributions made after the post-termination transition period are taxed under the regular Subchapter C provisions.

Because of the large number of occurrences that can terminate a corporation's S election, an S corporation and its shareholders may be unaware of a termination until an IRS examination in a subsequent year brings the facts to light. In such situations where inadvertent termination relief may not be available, the period within which to make post-termination distributions may already have elapsed.

> Example: A shareholder of an S corporation irrevocably transferred stock to a trust that he believed in good faith to be an eligible S corporation shareholder. Two years later, an IRS examination determined that the trust was not eligible. Under the terms of the trust agreement, the stock cannot be transferred out of the trust. Accordingly, inadvertent termination relief is unavailable. Since the post-termination transition period has elapsed, the corporation is unable to make a tax-free distribution of its AAA.

We recommend a broadening of the definition of post-termination transition period with respect to the 120-day period following a determination that the corporation's election had terminated for a previous taxable year.

EXPANSION OF RECOVERY PERIOD FOR NONRESIDENTIAL PROPERTY

The present Budget Reconciliation Bill contains a provision extending the depreciable life (the "recovery period") of nonresidential realty from its present 31.5 years to 39 years. We have previously testified in opposition to this provision. If, however, Congress believes it important to lengthen the life of business realty, we believe you should consider the following. As the building life for tax depreciation approaches its economic life, tenants and landlords paying for leasehold improvements may become more disadvantaged. Tenants with short-term leases must depreciate improvements for which they pay over the statutory life (which would now be 39 years), even though a lease may be for only 10 or 15 years.

As to landlords, improvements are usually specialized to the particular tenant's needs and do not usually have much, if any, economic value at the conclusion of the lease period. As a result of this, landlords who are already disadvantaged by the present 31.5 year recovery period would be put at an even greater disadvantage as a result of the requirement to use a 39-year life for leasehold improvements.

> Example: Assume a landlord agrees to invest $390,000 for tenant improvements in order to entice a tenant to sign a ten-year lease. At the end of the lease term, the landlord would have depreciated 10/39 of the cost but is not entitled to write off the remaining $290,000 of cost even though it has little or no economic value. Such cost is capitalized as a part of the building cost and cannot be written off even if the associated assets are abandoned. If at that time the landlord must make the same arrangement in order to secure a new tenant ($390,000 of additional tenant improvements) he now has an undepreciated balance of $680,000 (the remaining $290,000 plus the new $390,000) for tenant improvements that are worth $390,000.

If the cost recovery period for business real estate is extended to 39 years, we believe Congress should legislate a separate, shorter, depreciation class for leasehold improvements and for other known shorter-life assets, which presently are keyed to the recovery period of the overall building.

* * * * *

Once again, we appreciate the opportunity to present our views here today and we stand ready to assist you in any way.

1. These figures are for 1990, the most recent year for which data is available. *See*, "Table 13.—Corporation Income Tax Returns: Balance Sheet, Income Statement and Tax Items for Specified Income Years, 1970-1990", *SOI Bulletin*, Vol 12, Number 4 (Spring 1993).

2. References to the pamphlet are to the *Joint Committee on Taxation Staff Description (JCS-8-93) of Miscellaneous Tax Proposals Scheduled for Hearings June 17, 22, and 24, before House Ways and Means Select Revenue Subcommittee, Issued June 16, 1993.*

3. This proposal was included in H.R. 11, the *Revenue Act of 1992*, which was vetoed by President Bush.

4. This proposal was included as a measure in H.R. 13, *the Tax Simplification Act of 1993*.

5. *See*, Technical Advice Memorandum 9245004 (July 28, 1992), a form of nonprecedential administrative guidance.

Mr. HOAGLAND. Gentlemen, as I understand it, none of the rest of you is addressing this issue, right?

Oh, you are, Mr. Corneel?

We will go to Mr. Corneel, and then those of you who did subchapter S could leave, and then we can get to the final interests.

Mr. Corneel, do you want to proceed? Mr. Corneel is here from Boston on behalf of Sullivan & Worcester.

STATEMENT OF FREDERIC G. CORNEEL, SENIOR PARTNER, TAX DEPARTMENT, SULLIVAN & WORCESTER, BOSTON, MASS.

Mr. CORNEEL. Sullivan & Worcester, we are a law firm; I am the senior partner in the tax department. We have clients who are interested in this legislation, which is sponsored by Representative Neal, that would permit a family's "sprayed" trust to own stock in the subchapter S corporation. Let me give an example of what we are speaking of.

The trust for the benefit of my wife, my children and my grandchildren, it is for the benefit of that group, and that is why it is called a family trust. Not one of these family members gets a specific interest in the trust. Rather, the trustees are given discretion to distribute income each year to whatever family member may need it. Somebody may have medical expenses, somebody may be going to college; and the trustees are free to divert the income in any particular year to the particular family member that is in need. And that is why it is called a "sprayed" trust. If there is no need in a particular year to distribute all of the income, it can be accumulated.

This kind of family "sprayed" trust is the most frequently used device for families that are well off, but are not really rich. If they are really rich, then you can give 25 percent to the son or 10 percent to a grandchild or something like that, and you know that that particular person's needs will be taken care of. But by having it all in a single trust, we have the discretion and the flexibility to give them more limited income wherever it may be needed in a particular year. That is the advantage of these family trusts, family "sprayed" trusts; that is why they are used so often.

Unfortunately, they cannot be used to hold subchapter S stock, which is often the principal asset in the family that has a family business. subchapter S says, if you want to have trust ownership, there can be only one beneficiary, and so in my case I have to have one trust for my wife and one for my children, each child separately, one separately for each grandchild. I lose the flexibility, and I also have the additional cost of having a whole bunch of trusts where a single trust would do and would serve better.

We have worked out the details of this legislative proposal with the staff of the Joint Committee to make sure that it doesn't open the door to tax avoidance. We have done that in a number of respects; I will just mention one.

We say that any subchapter S income that is allocated to the family "sprayed" trust must be taxed at the highest rate, even though the family trust may be allocated only $100 in a particular year of subchapter S income; nevertheless, that income is going to be taxed at the highest rate, and in that way we assure that the

"spray" power cannot be used in order to allocate income to beneficiaries who are in lower tax brackets.

Now, just addressing the question that you asked us to address, Mr. Chairman, I heard Mr. Samuels urge you to defer consideration of all S proposals until the Treasury had a chance to study all of this in great detail and to make comparisons with limited partnerships and limited liability companies.

Well, limited partnerships and limited liability company interests can be owned by family "sprayed" trusts. It is only the subchapter S that is excluded right now. The Treasury review, which hasn't begun yet, would obviously take a great deal of time, and that is a hardship to owners and families owning small businesses. I would really urge you to take individual simplification proposals like this, simplification in the sense that you can have just one family trust owning the stock and not lose taxes because it would pay taxes at the highest rate, act on these simplification proposals as they come along whenever they seem to make sense, rather than unnecessarily to continue to burden owners of small businesses, family businesses with unnecessary restrictions.

I notice that all of the other subchapter S proposals that have come before you today urge you to permit ownership of subchapter S stock by family "sprayed" trusts. So I very much urge you to give favorable consideration to this proposal.

Thank you very much.

Mr. HOAGLAND. Thank you, Mr. Corneel.

[The prepared statement follows:]

Testimony of Frederic G. Corneel of Boston
Before the Subcommittee on Select Revenue Measures
of the House Ways and Means Committee

Chairman Rangel and Subcommittee Members:

I appreciate the opportunity to submit a proposal that would simplify the ownership of S corporations. The proposal, a copy of which is attached, would simplify estate planning for families owning S corporation shares by permitting, within very strict limits, ownership of such shares by discretionary trusts. The legislative language is the same as proposed legislation passed by the Senate in 1992 as section 4505 of its version of H.R. 11, except for one change, described below, worked out with the staff of the Joint Committee on Taxation.

Personal. I am the senior partner in the tax department of Sullivan & Worcester, attorneys, in Boston, Massachusetts. Our firm has clients who are owners of family corporations and other clients that function as trustees of trusts holding family corporation stock and who may compensate my firm for our efforts in connection with the proposal here submitted. However, quite aside from any benefit to particular clients, I believe that our proposal would simplify the ownership of many S corporations and thus produce a substantial practical benefit, a benefit which I believe is unlikely to involve any meaningful revenue loss.*

Subchapter S Background. From the time the Internal Revenue Code first authorized S corporations, it has restricted their ownership to U.S. individuals. Only gradually have these limitations been enlarged to permit limited trust ownership. The reluctance to permit trust ownership has been grounded in the concern that such ownership might be used to circumvent basic subchapter S principles. Therefore, generally speaking, under present law a trust can own S corporation stock only if all of the income allocable to the trust is currently taxed to a designated U.S. individual.

This result may now be achieved in two ways: The subchapter S stock may be held by a grantor trust which is disregarded for income tax purposes or by a Qualified Subchapter S Trust, which requires that all of the income be distributed and taxed to a single beneficiary.

The requirement that there be only one beneficiary to whom the income of trust owned S corporations shares is allocated has made it impossible for commonly used discretionary family trusts to hold shares in S corporations.

Reasons for Family Trusts. Family trusts are now commonly used to hold and administer that portion of the estate that does not pass to the surviving spouse. Rather than giving specific shares in the family trust to the surviving spouse, children and grandchildren, the modern family trust provides that it is established for the benefit of the entire family. The trustee is then given discretion to distribute ("spray" or "sprinkle") income or principal to one or more members of the family, depending upon their needs and resources, or if there is no

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*I am former Chairman of the Tax Section of the Massachusetts Bar Association and of the Small Business and Standards of Tax Practice Committees of the Tax Section of the American Bar Association. I recently completed a two-year term as a member of the Commissioner's (Internal Revenue Service) Advisory Group. I have for many years been co-chairman of the ALI/ABA Program on Sophisticated Estate Planning and have taught courses on Tax Planning and Estate Planning in the Graduate Tax Program of Boston University School of Law. However, I am not making these proposals on behalf of any of these organizations.

current need, to accumulate the income. Such arrangements provide needed flexibility to adjust distributions to situations that cannot be foreseen when the trust is established.

Present Complexities. In order to accommodate their estate planning goals to the limitations of subchapter S applicable to trust ownership, some owners of S stock have established multiple trusts, one or more for each of a number of beneficiaries, and have given the beneficiaries withdrawal rights which result in the trusts technically becoming grantor trusts not subject to limitations applicable to Qualified Subchapter S Trusts. In Private Letter Ruling 8342088, an unspecified number of shareholders of an S corporation set up twenty-six such trusts, which might be consolidated into thirteen on the happening of certain events. In Private Letter Ruling 9009010, one individual set up twenty-four such trusts (under seventeen separate trust instruments, one of which had eight separate shares). Surely a statute which results in such a multiplicity of trusts to meet normal estate planning requirements is in need of simplification.

The Proposal. The amendment I propose would permit discretionary family trust ownership and at the same time preserves the basic principles of subchapter S. Spray trust ownership of stock would be permitted but only under these conditions:

1. The only potential current beneficiaries who might in the discretion of the trustees receive distributions, would be individuals who are U.S. citizens or residents.

2. For purposes of the 35 shareholder limit, each potential current beneficiary would count as a separate shareholder. Thus a family trust for the benefit of the widow, two children and three grandchildren would count as six shareholders.

3. To prevent "income shifting" to beneficiaries in lower income tax brackets, all of the S income received by the family trust would be taxed to the trust at the highest individual tax rate. The trust will have to pay this tax whether it accumulates or distributes the income and regardless of the tax bracket of the individual beneficiaries. Since income tax at the highest rate had been paid on the trust's income, distributions by the trust to the beneficiaries would be tax-free.

4. The only permitted potential future beneficiary of the trust, other than a U.S. individual would be a charity holding a contingent interest. This permits the normal kind of provision for the catastrophe that the entire immediate family is wiped out, in which event the trust assets, rather than passing by intestacy to more remote family members, go to charity. But once a charity becomes a potential current beneficiary, the trust has only 60 days in which to dispose of the stock. If it fails to do so, the corporation no longer qualifies under subchapter S.*

Impact of Proposal. These rules are likely to result in higher income taxes paid on the S income if the stock is held by a discretionary family trust rather than outright by children or grandchildren who are not in the top tax bracket. Therefore, some families owning S stock may choose not to use spray trusts to hold S stock. But others will gladly accept the income tax consequences of the proposal in order to have the greater estate planning flexibility of a spray trust.

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*The provision described under 4, represents the only change from Section 4505 of the Senate version of H.R. 11, although no substantive change from the legislative proposal on which that section was based.

Based upon my own practice experience and that of others with whom I have discussed it, this proposal will not have a meaningful impact on revenue by leading to a proliferation of S corporations. Clients have not chosen C rather than S for family corporations because of their desire for discretionary trust ownership of the family corporation. The important factors that have barred S elections relate to the nature of the business (such as banking and insurance), the number of shareholders (more than 35), the nature of the shareholders (such as venture capital partnerships), the desire for more than one class of stock and the presence of wholly owned subsidiaries.

Where broad family participation in an S corporation is desired for estate planning purposes, stock is now issued directly to children, grandchildren or to the limited types of trusts permitted by present law. A discretionary family trust is used for the family's other assets, but the benefits of a discretionary trust are foregone for the S stock - although, as indicated by the cited Private Rulings, complex substitutes for a simple discretionary trust may be attempted.

It follows that if the proposal were enacted, the result would not be to increase significantly the number of S corporations. But those S owners who desired to provide for continuity of family ownership through use of a discretionary family trust would be able to place their S shares into such a trust, rather than using the other less flexible and frequently more complex arrangements referred to.

Summary. Unlike other trust proposals, this proposal does not change any of the basic principles of subchapter S. Rather it permits the owners of subchapter S corporation stock to dispose of the family business in the same way as the balance of their assets without the need of separate and complex arrangements. Altogether, I believe that the proposal would make a significant contribution to facilitating the passage of ownership of a family business from one generation to the next and to simplifying the legal arrangements necessary for such passage, all without opening loopholes in subchapter S.

Many thanks for your thoughtful consideration.

Sincerely,

Frederic G. Corneel

Frederic G. Corneel
Sullivan & Worcester
Boston, Massachusetts

SEC. XXXX CERTAIN TRUSTS PERMITTED TO BE SHAREHOLDERS IN S CORPORATIONS.

(a) GENERAL RULE. -- Subparagraph (A) of section 1361(c)(2) (relating to certain trusts permitted as shareholders) is amended by inserting after clause (iv) the following new clause:

"(v) An electing small business trust."

(b) CURRENT BENEFICIARIES TREATED AS SHAREHOLDERS.-- Subparagraph (B) of section 1361(c)(2) is amended by adding at the end thereof the following new clause:

"(v) In the case of a trust described in clause (v) of subparagraph (A), each potential current beneficiary of such trust shall be treated as a shareholder; except that, if for any period there is no potential current beneficiary of such trust, such trust shall be treated as the shareholder during such period."

(c) ELECTING SMALL BUSINESS TRUST DEFINED.--Section 1361 is amended by adding at the end thereof the following new subsection:

"(e) ELECTING SMALL BUSINESS TRUST DEFINED.--

"(1) ELECTING SMALL BUSINESS TRUST.--For purposes of this section--

"(A) IN GENERAL.--Except as provided in subparagraph (B), the term 'electing small business trust' means any trust if

"(i) such trust does not have as a beneficiary any person other than an individual or estate or an organization described in Section 170(c) which holds a contingent interest and is not a potential current beneficiary,

"(ii) no interest in such trust was acquired by purchase, and

"(iii) an election under this subsection applies to such trust.

"(B) CERTAIN TRUSTS NOT ELIGIBLE.--The term 'electing small business trust' shall not include--

"(i) any qualified subchapter S trust (as defined in subsection (d)(3)) if an election under subsection

(d)(2) applies to any corporation the stock of which is held by such trust, and

"(ii) any employees' trust described in section 401(a) and exempt from tax under section 501(a).

"(C) PURCHASE.--For purposes of subparagraph (A), the term 'purchase' means any acquisition if the basis of the property acquired is determined under section 1012.

"(2) POTENTIAL CURRENT BENEFICIARY.--For purposes of this section, the term 'potential current beneficiary' means, with respect to any period, any person who at any time during such period is entitled to, or at the discretion of any person may receive, a distribution from the principal or income of the trust. If a trust disposes of all of the stock which it holds in an S corporation, with respect to such corporation, the term 'potential current beneficiary' does not include any person who first met the requirements of the preceding sentence during the 60-day period ending on the date of such disposition.

"(3) ELECTION.--An election under this subsection shall be made by the trustee. Any such election shall apply to the taxable year of the trust for which made and all subsequent taxable years of such trust unless revoked with the consent of the Secretary.

"(4) CROSS REFERENCE.--

"For special treatment of electing small business trusts, see section 641(d)."

(d) TAXATION OF ELECTING SMALL BUSINESS TRUSTS.--Section 641 (relating to imposition of tax on trusts) is amended by adding at the end thereof the following new subsection:

"(d) SPECIAL RULES FOR TAXATION OF ELECTING SMALL BUSINESS TRUSTS.--

"(1) IN GENERAL.--For purposes of this chapter--

"(A) the portion of any electing small business trust which consists of stock in 1 or more S corporations shall be treated as a separate trust, and

"(B) the amount of the tax imposed by this chapter on such separate trust shall be determined with the modifications of paragraph (2).

"(2) MODIFICATIONS.--For purposes of paragraph (1), the modifications of this paragraph are the following:

"(A) Except as provided in section 1(h), the amount of the tax imposed by section 1(e) shall be

determined by using the highest rate of tax set forth in section 1(e).

"(B) The exemption amount under section 55(d) shall be zero.

"(C) The only items of income, loss, deduction, or credit to be taken into account are the following:

"(i) The items required to be taken into account under section 1366.

"(ii) Any gain or loss from the disposition of stock in an S corporation.

"(iii) To the extent provided in regulations, Sate or local income taxes or administrative expenses to the extent allocable to items described in clauses (i) and (ii).

No deduction or credit shall be allowed for any amount not described in this paragraph, and no item described in this paragraph shall be apportioned to any beneficiary.

"(D) No amount shall be allowed under paragraph (1) or (2) of section 1211(b).

"(3) TREATMENT OF REMAINDER OF TRUST AND DISTRIBUTIONS.--For purposes of determining--

"(A) the amount of the tax imposed by this chapter on the portion of any electing small business trust not treated as a separate trust under paragraph (1), and

"(B) the distributable net income of the entire trust,

the items referred to in paragraph (2)(C) shall be excluded. Except as provided in the preceding sentence, this subsection shall not affect the taxation of any distribution from the trust.

"(4) TREATMENT OF UNUSED DEDUCTIONS WHERE TERMINATION OF SEPARATE TRUST.--If a portion of an electing small business trust ceases to be treated as a separate trust under paragraph (1), any carryover or excess deduction of the separate trust which is referred to in section 642(h) shall be taken into account by the entire trust.

"(5) ELECTING SMALL BUSINESS TRUST.--For purposes of this subsection, the term 'electing small business trust' has the meaning given such term by section 1361(e)(1)."

(e) EFFECTIVE DATE.--The amendments made by this section shall apply to taxable years beginning after the date of the enactment of this Act.

SULLIVAN & WORCESTER
ONE POST OFFICE SQUARE
BOSTON, MASSACHUSETTS 02109
(617) 338-2800
TELECOPIER NO. 617-338-2660
TWX 710-321-1976

IN WASHINGTON, D.C.
1025 CONNECTICUT AVENUE, N.W.
WASHINGTON, D.C. 20036
(202) 775-8190
TELECOPIER NO. 202-293-2275

IN NEW YORK CITY
767 THIRD AVENUE
NEW YORK, NEW YORK 10017
(212) 486-8200
TELECOPIER NO. 212-758-2151

Supplemental Written Testimony of Frederic G. Corneel

June 25, 1993

Chairman Charles B. Rangel and
Members of the Subcommittee on
Select Revenue Measures of the
House Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, DC 20215

Att: Janice Mays, Chief Counsel and Staff Director,
Committee on Ways and Means U.S. House of
Representatives

Re: Proposed Subchapter S Amendment

Dear Mr. Chairman:

At the hearing which you held on June 22, I spoke in support of a legislative proposal to permit subchapter S stock to be held by a discretionary family trust. The purpose of the proposal was to simplify the passage of the ownership of a family business from one generation to the next, reducing the non-tax costs and administrative complexities which subchapter S now imposes. The specific wording had been worked out with the staff of the Joint Committee on Taxation to assure that this change in subchapter S would not open the door to tax avoidance.

At the hearing I saw for the first time the Treasury's response to this proposal as set out as item D3 in Mr. Samuel's written position statement. The purpose of this letter is to explain more fully than I was able to do in my oral testimony the reasons why I strongly disagree with the Treasury's position statement.

The Treasury's statement with respect to my proposal was as follows:

3. CERTAIN TRUSTS ELIGIBLE TO HOLD STOCK IN S CORPORATIONS.

ADMINISTRATION POSITION. DO NOT SUPPORT.

The Administration understands the objectives of allowing customary estate planning tools to be available in the case of a family-owned S corporation. However, if significant changes, such as this proposal, are to be made to the S corporation system, the proposals should be fashioned pursuant to a comprehensive, deliberate process, rather than on a piecemeal basis. This approach requires a careful consideration of the objectives of the S corporation regime, how those objectives can better be achieved and how any changes would interact with the other current forms of business organization such as limited partnerships and limited liability companies. The most recent comprehensive reform was enacted by the Subchapter S Revision Act of 1982. That legislation was preceded by detailed hearings on the problems facing S corporations and the objectives to be achieved in amending the rules. The Congress should follow a similar course today if it is to consider such comprehensive reforms.

If you will compare the paragraph just quoted to the immediately following one in the Treasury's statement, you will see that except for the introductory phrases, the two are identical. However, the second addresses the much more extensive revision proposals submitted by the AICPA and representatives of the Tax Section of the American Bar Association. The proposal I submitted was a single simplification proposal; what was submitted by AICPA-ABA representatives, running as we were told 80 pages, involves many substantive changes, including the expansion of the number of permitted shareholders and the authorization of several classes of stock.

I agree that broad-scaled proposals relating to subchapter S require a general review of subchapter S. But clearly, no broad-based review is required to consider one very small and specific simplification proposal carefully drafted in consultation with the Joint Committee staff to prevent tax avoidance.

The present provision in subchapter S, which prevents use of a normal discretionary Family Trust to hold subchapter S stock, requires the creation of separate trusts for each family member or other complicated and expensive arrangements discussed in my earlier written testimony. Contrary to the Treasury, I would urge your Committee to adopt this policy: Whenever taxpayers

present to the Committee evidence of an unnecessary and intrusive burden created by the Code which can be cured without material revenue loss, such cure should be promptly provided by an amendment to the law, rather than to continue unnecessarily to burden the taxpayers.

Note that the Treasury statement speaks of a consideration of how the proposed change "would interact with the other current forms of business organizations, such as limited partnerships and limited liability companies". With respect to the change we are proposing, the situation is clear: Discretionary Family Trusts may hold both limited partnership interests and interests in limited liability companies. It is only subchapter S which generally precludes trust ownership unless the trust has a single beneficiary.

In brief, I submit that consideration of a very narrow amendment intended to simplify estate planning by owners of family-owned S corporations should not be deferred until the Treasury determines to launch and eventually concludes a "comprehensive, deliberate process" to review all of subchapter S.

I appreciate very much the courtesy shown to me at the hearing and your thoughtful consideration of our proposal.

Sincerely,

Frederic G. Corneel

FGC/bg

cc: Rep. Richard E. Neal

Mr. HOAGLAND. Mr. Cardin.

Mr. CARDIN. Thank you, Mr. Chairman. First, let me say that looking over Treasury's recommendations, perhaps we should be pleased that the recommendations do not support, because most on the list they oppose; at least we didn't get any opposition.

And, secondly, it is interesting to point out that the Treasury is saying that they would like to study the issue and come forward with a comprehensive recommendation that they are party to, rather than respond to the individual recommendations that have been made.

I don't think that precludes our committee from acting, and I just really wanted to make that point for the record.

I want to thank all of you for your testimony. It has been a coalition of different groups that have come together and that recognize it is time to modernize the subchapter S corporation laws.

It should be pointed out that subchapter S was put into the tax law to simplify for small businesses the ability to use a single-tier tax; and with the tax reform that we are looking at this year, a person who uses the S corporation is going to be further penalized by higher individual rates, compared to what is being done with the corporate rates, so there is a real cost involved in simplification.

But at least we should try to change the law to make it easier for small companies and businesses to be able to use the S corporation.

As I look at the recommendations that are being suggested, they are basically to ease the restriction on a number of shareholders, as well as to eliminate some of the real traps that a taxpayer may find himself in on an audit, an unintended result that if they would have done things a little bit differently, they perhaps would qualify.

I guess the question I would like to ask, there are several recommendations here. If you had to put a priority on what needs to be done at the top of your list, could you help us maybe to pin down what you would put at the top of your list to accomplish? Maybe we can sort of get Treasury to go along with one or two points here.

Mr. ROSE. If I might, Mr. Cardin, I guess the recommendations do fall into several categories; and I imagine the category that we would put at the top of the list would be capital expansion, the ability to access capital markets. S corporations are really prejudiced in their ability to tap into capital markets and obtain financing, either in the form of loans or capital contributions for instruments that investors normally would want. And as a result, the S corporation is severely disadvantaged in its ability to expand into new areas, or even to grow; which puts the S corporation in a poor position vis-a-vis its competitors.

So I think the access to capital markets as a category would be something that we would probably look at—that I would look at as a very high priority.

Mr. CARDIN. Do you agree or disagree?

Mr. PADWE. You might also notice that a number of these recommendations actually are recommendations that have been made by your chairman or that were enacted by the Congress last year,

and one would hope that those would not be particularly controversial.

Mr. CARDIN. Recommended in some cases by the now Secretary of the Treasury, so maybe.

Mr. PADWE. I think that, in addition, the removal of the traps for the unwary—and there are several of them in there—that these sections are more technical than others, and would be very, very important to try and accomplish.

I wonder if I could just make one comment with respect to an implied point that you made, Mr. Cardin, on the timing here? Treasury is an important player in any legislative action, and obviously their input is critical to the process and very desirable. The only concern on that score, I think that we would have, would be the timing of their input. I would just remind the committee—the subcommittee that, beginning in 1994, if you will, when rates are fully phased in under the budget reconciliation bill now before the Congress, C corporations will, if their taxable incomes exceed $10 million, be paying a 35-percent rate. S corporations through their owners, if their taxable incomes exceed $250,000, could be paying a 39.6 percent statutory rate, and over a 40 percent—roughly 42 percent marginal rate.

If these corporations, through their owners, are to pay the rates of the 1990s, we think it is important, in terms of timing, that their ability to compete in the 1990s also be kept current.

Mr. CARDIN. I am glad you gave the specifics. That is the point I was raising, I guess, in my preliminaries, is that there is going to be a higher cost to pay for the simplification of S corporations because of the different rates and the changes, and assuming that they are enacted.

Mr. PADWE. Yes, sir.

Mr. LEIBTAG. I would just like to reiterate that the committee needs to realize the importance of the capital formation. This encompasses a number of proposals in here. I think that was a point Mr. Rose was making, that the issue of the back-to-back loans that I talked about, the availability of S corporations to issue preferred stock, the availability of S corporations to issue straight debt to noneligible shareholders, are all separate, specific proposals that all come under that rubric of capital formation. From what I see in my daily practice, this tends to be one of the biggest stumbling blocks for small business owners.

Mr. CARDIN. Mr. Corneel.

Mr. CORNEEL. I don't disagree with anything that has been said, but I would like to urge you, really, to look at the specific proposals—whether it is in this area or in other areas, too—and if they seem to simplify life for people, you should act on them without seeing, A, how does this fit into a very large picture, because these simplifications really are all intended to remove what seem to be unnecessary and unintentional burdens on taxpayers. The particular proposal to which I spoke, family-owned trust ownership of a subchapter S, is an example of that. And I am not saying it is the only one. But I would think specific simplification proposals are worth acting on, even though it may be decided to defer until some other time, look at the larger picture.

But I also agree, this is really the year to look at the larger picture as far as subchapter S is concerned.

Mr. CARDIN. Thank you. Thank you all.

Mr. HOAGLAND. Mr. Padwe, did you participate in the subchapter S Revision Act in 1982 and the formation of that bill?

Mr. PADWE. Not as part of an organized coalition, sir, no. The AICPA certainly did, but I was not with them at that time.

Mr. HOAGLAND. OK. Now, I am told by staff that that subchapter S Revision Act of 1982 originated in this committee, in this subcommittee, and was carried through and enacted after a lot of work and deliberation involving all parties. Do you have any thoughts on what kind of a model we might—those of us that are interested in subchapter S modernization—and I certainly am—what sort of a course we might take in achieving that?

Mr. Rose, do you have any thoughts, understanding we have an unwieldy House, an unwieldy Senate, and a Treasury Department to bring on board?

Mr. ROSE. Mr. Chairman, over the past few years, we have met with representatives of the Treasury Department and representatives of the tax committees in the two Houses, and we have been meeting with staff members with a view to trying to get a package together that not only met the technical needs of practitioners and their clients, but also would be practical and workable and palatable from the perspective of the legislature. We have been working on the Senate side with staff members of the Senate Finance Committee, Senators Pryor and Danforth, who have drafted or have a draft of a proposed bill, which I understand has not yet been submitted, but I understand will be submitted shortly; and it perhaps would be appropriate for members of the staff of this committee to contact those people over there and see if perhaps some concerted effort could be made to have some legislation introduced on both sides.

Mr. HOAGLAND. Mr. Padwe, do you have any thoughts on how we might get the job done?

Mr. PADWE. I am sorry?

Mr. HOAGLAND. Do you have any thoughts on what sort of structure we might set up in order to expedite some work in this area?

Mr. PADWE. Well, as Mr. Rose said, a great deal of work has already been done; and I think what you are talking about, perhaps, is formalizing the structure, some sort of a working group or some kind of a group between government and the private sector; and surely there are precedents for that.

I would just like to emphasize that all of us—all of us who have been testifying on the S corporation issues would, I am sure, support this, would like to see it happen, and would like to urge that time be considered as well in trying to move that forward.

Mr. HOAGLAND. OK. Thank you.

Mr. Neal, Mr. Cardin, any final questions?

Mr. Rose, you have come in from San Francisco for this hearing?

Mr. ROSE. Yes, sir.

Mr. HOAGLAND. Mr. Corneel from Boston, you have come down for this hearing?

Mr. CORNEEL. Yes, sir.

Mr. HOAGLAND. And from Washington, Mr. Padwe, and Mr. Permison, all the way from Baltimore.

Mr. PADWE. All the way from 14th Street.

Mr. HOAGLAND. It certainly is an indication of your interest in this issue that you would travel here, and we appreciate it. We will see if we can get some kind of structure set up to move this along.

So thank you for coming. Those of you that have already testified, please feel free to leave.

Mr. HOAGLAND. Mr. Hamrick, would you like to present us with your testimony?

STATEMENTS OF STEPHEN HAMRICK, CHAIRMAN, INVESTMENT PROGRAM ASSOCIATION, AND SENIOR VICE PRESIDENT AND DIRECTOR, PRIVATE INVESTMENTS, PAINE WEBBER, INC., WEEHAWKEN, N.J., AND BRUCE VINCENT, TRUSTEE AND CHAIRMAN, LEGISLATIVE AND REGULATORY AFFAIRS COMMITTEE, INVESTMENT PROGRAM ASSOCIATION, AND SENIOR VICE PRESIDENT, SWIFT ENERGY CO., HOUSTON, TEX.

Mr. HAMRICK. Congressman Hoagland and members of the subcommittee, I appreciate the opportunity to be here this morning. I am Steve Hamrick, director of private investment at Paine Webber, where we originate and sell limited partnerships as investment opportunities for individuals and institutional investors.

I am also chairman of the Investment Program Association, the national association representing most people who invest and raise capital through widely held limited partnerships and similar vehicles. These are long-term investments consisting of nontraded securities in sectors like real estate, energy, and research and development.

For example, I would point out that the great majority of capital for low- and moderate-income housing development has been achieved through limited partnerships organized by members of the IPA. Boston Capital and Boston Financial, for example, are very prominent in that arena.

While the need for more and better housing grows across our Nation, I have to tell you that our ability to raise funds from investors is seriously undermined by the extraordinarily complex tax reporting burden that is imposed on investors. Small investors are finding that their annual returns are fully eaten up by the cost of simply doing the tax reporting.

On a personal note, my mother, who is a retired high school math teacher, did her own tax return every year right up until the year in which her son put her in a limited partnership.

The brokers and the financial planners who in the past recommended these investments to their clients have begun to avoid doing so, because they know that their clients hate the time and the expense involved in preparing their tax returns if they own one of these partnerships.

Under the proposal to allow partnerships to elect section 469(k) treatment, this offensive burden can be removed; and our ability to raise capital for investments, like low-income housing, will be renewed.

I would like to have Bruce Vincent explain the proposal. I conclude by urging you to do what you can to have this provision and the partnership simplification provisions contained in H.R. 13 included in the package of tax measures you may be considering soon.

It was suggested earlier that all of these proposals have come with pluses and minuses. Tax simplification for partnerships must be the exception. There is no opposition. Even Treasury is not opposed to this change. It is revenue positive. We need this.

Mr. VINCENT. On behalf of the IPA, I would like to commend the Chairman of the Ways and Means Committee, Congressman Rostenkowski, Chairman Rangel, Chairman of the subcommittee, as well as the members of the subcommittee, for taking the time to review this much-needed change in tax simplification for limited partners of large nonpublicly traded partnerships.

My name is Bruce H. Vincent and I serve as the chairman of the Investment Program Association Committee on Legislative and Regulatory Affairs. The IPA is pleased to be here today to discuss an important tax simplification initiative. IPA has devoted considerable time and resources to this issue and has worked diligently with the staffs of the tax writing committees and the Treasury in conjunction with their review of this proposal. I have prepared formal written testimony that has been submitted for the record. At this time, I would like to make a few comments on the business and economic implications of tax simplification.

Historically and prior to 1986, many people invested through limited partnerships for the tax benefits that were obtained through such investments. In today's world, investments in limited partnerships are driven by economic return and asset allocation strategies for one's financial portfolio. Large pension funds, insurance companies, endowments, and foundations employ asset allocation strategies which drive their investment policies and are able to invest in different asset classes of different industries to provide better overall economic return and decreased volatility in their financial portfolios.

Our firm and other members of the IPA provide investment expertise in different asset classes and industries that help provide this for individual investors and small investment entities. We have found that the complicated tax burden that is currently in place has both driven the cost up for individual investors and inhibited investment in these different areas.

The IPA asks for your support of this tax simplification initiative for existing and newly formed widely held partnerships and believes that, in doing so, you will decrease the paperwork burden and compliance costs for individual investors. This will make these investors more willing to provide capital for investment elsewhere; and, more importantly, this tax simplification measure will stimulate investment in many industries that are important for the domestic economy.

Thank you.

[The prepared statements follows:]

Investment Program Association
Suite 1000
607 14th Street, NW
Washington, DC 20005
(202) 775-9750
(202) 331-8446 FAX

Testimony of Stephen H. Hamrick, Chairman of the Investment Program Association, before the Subcommittee on Select Revenue Measures, Committee on Ways and Means, U.S. House of Representatives on Tuesday, June 22, 1993

I am Steve Hamrick, Director of Private Investments at PaineWebber where we originate and sell limited partnerships as investment opportunities for individual and institutional investors. I am the Chairman of the Investment Program Association, the national association of organizations raising capital through limited partnerships. We represent most major program sponsors and the Wall Street firms who distribute these investments.

Congressman Rangel, thanks for this opportunity to briefly discuss an important simplification proposal that can jump start capital formation in a number of sectors like energy, equipment leasing, real estate and venture capital. Before I introduce Bruce Vincent who will discuss this proposal, I would like to call your attention to a subsidized housing development completed on 126th Street in the East Harlem Triangle Urban Renewal Area of Manhattan. This project was funded in 1981 by a limited partnership that constructed a 255 unit, 11 story apartment building which brought human renewal together with urban renewal. Over 10,000 families applied to live in this low income housing project.

The great majority of the capital formation for low and moderate income housing development such as this project has been achieved through limited partnerships organized by the members of the IPA.

While the need for more and better housing grows across our nation, I have to tell you that our ability to raise these funds from investors -- even with special tax credit available to them for such investment -- is seriously undermined by the overly complex tax reporting burden imposed on them. Simply put, those brokers and financial planners who in the past recommended these investments to their clients have begun to avoid doing so because they know that their clients hate the time and expense involved in filing their tax returns if they own one of these partnerships.

Under the proposal to allow partnerships to elect Section 469(k) treatment, this offensive burden can be removed and I firmly believe our ability to use the partnership vehicle for raising capital will be renewed.

I would like to have Bruce Vincent explain the proposal and conclude by urging you to do all that you can to have this provision and the partnership simplification provisions contained in H.R. 13 included in the final reconciliation package.

Investment Program Association
Suite 1000
607 14th Street, NW
Washington, DC 20005
(202) 775-9750
(202) 331-8446 FAX

Testimony of Bruce H. Vincent, Chairman, Legislative and Regulatory Affairs Committee of the Investment Program Association and Senior Vice President, Swift Energy Company, before the Subcommittee on Select Revenue Measures, Committee on Ways and Means, June 22, 1993

On behalf of the IPA, I wish to commend the Chairman of the Committee on Ways and Means, Congressman Rostenkowski, and you, Congressman Rangel as Chairman of the Subcommittee for making time to review an additional important tax simplification initiative for limited partners in large partnerships and to seriously consider this much needed change.

My name is Bruce H. Vincent. I serve as Chairman of the Investment Program Association's Legislative and Regulatory Affairs Committee. The IPA has devoted considerable time, energy and resources to an effort to encourage the IRS, the Treasury Department, and the congressional tax writing committees to seriously consider simplifying the tax reporting and compliance system for individual limited partners who hold interests in large, widely-held partnerships.

We are delighted that the IRS, the Treasury and the Congress have recognized the mutual interest we all have in creating a simpler system under which large partnerships and limited partners can more successfully attempt to comply with the Federal income tax laws. We strongly support the simplified reporting rules for large partnerships contained in H.R. 13. We believe the addition of the provision which is the subject of today's hearing is critical to the success of our joint efforts to simplify and improve the ability of limited partner investors to comply with the Federal income tax laws.

H.R. 13 provides that large partnerships (generally a partnership with at least 250 partners or an electing partnership with more than 100 partners) would be required to determine taxable income by applying all limitations and other provisions affecting the computation of taxable income at the partnership rather than the partner level. In addition, all elections affecting the computation of taxable income or any credit generally would be required to be made by the partnership.

Each partner would be required to separately take into account his or her respective distributive share of the following items, determined at the partnership level: (1) taxable income or loss from passive loss limitation activities; (2) taxable income from other activities (e.g.,portfolio income or loss); (3) net capital gain or loss; (4) tax-exempt interest; (5) net alternative minimum tax adjustments; and (6) tax credits.

H.R. 13 codifies these changes to permit large partnerships to compute partnership income, loss, minimum tax liability, capital gains and losses and tax credits at the partnership level and to flow through these items to individual limited partners in far simpler fashion. These proposed changes make it possible to significantly alter and simplify the form on which this information is transmitted to limited partners. These provisions have already been approved by the Congress as part of H.R. 11 in 1992.

We urge that this general approach be adopted, along with the additional important provision I will describe this morning.

--over--

To truly achieve a simplified reporting system for millions of limited partners with small investments in widely-held partnerships, the IPA believes that one additional item must be added to the large partnership simplification proposals contained in H.R.13. The IPA proposes that existing and newly formed widely-held, non-publicly traded partnerships be permitted to elect to be subject to Section 469(k) of the Internal Revenue Code of 1986, as amended.

Section 469(k) requires items of passive or portfolio income or loss, net passive or portfolio gain or loss, net alternative minimum tax adjustments, tax credits, etc. to be separately accounted for by publicly traded partnerships. Limited partners with interests in publicly-traded partnerships may not offset reported losses against their share of similar income or gain from other partnerships.

To simplify the compliance burden for limited partners holding interests in large, non-publicly traded partnerships, it is proposed that existing and newly formed such partnerships be permitted to elect to be subject to Section 469(k) and thus be permitted to maintain the record of currently non-deductible passive and portfolio losses for each limited partner and to report the deduction for passive or portfolio losses properly allocable to limited partners at such time as the electing partnership has passive or portfolio income against which to offset such losses or at the time a partner disposes of his entire partnership interest.

By adding this proposed change to the partnership simplification proposals, the Congress can help limited partners by reducing unnecessary complexity and at the same time achieve a small revenue increase for the Treasury. This change would spare the vast majority of individual limited partners from a totally unnecessary bookkeeping burden and the cost of annually retaining a tax professional to determine if they may have, at best, a small, insignificant deductible loss.

Limited partners want a simpler tax regime. They are willing to forego the possibility of a small tax deduction obtained only after the expenditure of tax preparer fees barely less than the value of the deduction. The IPA strongly urges your favorable action on this proposed change.

Investment
Program
Association

SIMPLIFIED FLOW-THROUGH FOR LARGE PARTNERSHIPS

Suspension of Passive Losses at Partnership Level

Present Law

A partnership is generally treated as a conduit for Federal income tax purposes. Each partner accounts separately for his distributive share of partnership income, gain, loss, deduction or credit. Limitations affecting the computation of taxable income generally apply at the partner level.

H.R. 13 (Identical to H.R. 11, approved by Congress in 1992)

Large partnerships (generally a partnership with at least 250 partners or an electing partnership with more than 100 partners) would be required to determine taxable income by applying all limitations and other provisions affecting the computation of taxable income at the partnership rather than the partner level. In addition, all elections affecting the computation of taxable income or any credit generally would be required to be made by the partnership.

Each partner would be required to separately take into account their respective distributive share of the following items, determined at the partnership level: (1) taxable income or loss from passive loss limitation activities; (2) taxable income from other activities (e.g.,portfolio income or loss); (3) net capital gain or loss; (4) tax-exempt interest; (5) net alternative minimum tax adjustments; and (6) tax credits.

Additional Simplification-Provide An Election at the Partnership Level to Suspend Passive Losses Under Section 469(k)

Section 469(k) requires items of passive or portfolio income or loss, net passive or portfolio gain or loss, net alternative minimum tax adjustments, tax credits, etc. to be separately accounted for by publicly traded partnerships. Partners may not offset these amounts against their share of the same items from other partnerships.

To simplify the compliance burden for limited partners holding interests in large, non-publicly traded partnerships, it is proposed that **existing and newly formed** such partnerships be permitted to **elect** to be subject to Section 469(k) and thus be permitted to maintain the record of currently non-deductible passive and portfolio losses for each limited partner and to report the deduction for such losses properly allocable to limited partners at such time as the electing partnership has passive or portfolio income against which to offset such losses or until a partner disposes of his entire partnership interest.

Thus, individual partners could be spared unnecessary complexity and costs for retaining a tax professional to determine if they have a small, insignificant, deductible loss for a taxable year.

Mr. HOAGLAND. Gentlemen, would the proposal result in loss to any partners? In other words, do you have any data showing whether any taxpayers will be negatively affected by the proposal?

Mr. HAMRICK. Our data concludes that limited partners would forego the current use of some small losses in certain instances if it were deemed by the general partner to be a change in their best interests; and further, there would be only a temporary loss substantially exceeded by the gain from the reduced cost of Federal income tax preparation.

Mr. HOAGLAND. All right.

Mr. Vincent, do you have any thoughts on that issue?

Mr. VINCENT. I concur with Mr. Hamrick's response. If you compare the cost of tax return preparation that partnership investors have to bear as well as the mental anguish that many of the investors go through, I think they would be quite happy to forego any loss deductions. I also believe that in many cases these passive losses cannot be offset against other passive income, and so must be deferred anyway.

Mr. HOAGLAND. OK. So what sort of overall revenue impact do you see?

Mr. HAMRICK. There is a revenue pickup estimated to be about $500,000.

Mr. HOAGLAND. Well, gentlemen, Mr. Samuels in his testimony, as you know, attached an analysis of various proposals; and you have, I am sure, seen this. The Treasury does not oppose the proposal you are presenting today. And it states, in the application of section 469(k), large partnerships may facilitate and eliminate the need for partners to track accumulated passive losses. So they have given it a favorable response.

Mr. VINCENT. We are pleased the Treasury has made that statement.

Mr. HOAGLAND. OK. Are there any final observations you might have?

All right. Thank you for your testimony today.

Let the record reflect that Mr. Kenneth Novack, who was scheduled to be part of this panel, had to cancel.

[The prepared statement follows:]

Testimony
of
KENNETH M. NOVACK
before
The Ways and Means Committee
United States House of Representatives
June 22, 1993

Mr. Chairman and Members of the Committee:

Thank you for the opportunity to present testimony on the issue of Subchapter S Corporations. First, I want to commend you, and the Committee, for your fine work in crafting new Subchapter S legislation in last year's bill, H.R. 11, which was vetoed by President Bush. This Committee must make many hard decisions which affect the lives of every American and I admire your courage and tenacity as you move forward with tax legislation this year. The Committee has a fine new member in Congressman Kopetski from my state, Oregon. He has been a great addition to our congressional delegation and his hard work, intelligence and integrity will serve the Ways and Means Committee well.

I am the President of Schnitzer Investment Corporation, which is part of a group of business interests owned by several generations of the Schnitzer family in Portland, Oregon. Schnitzer Investment Corporation traces its origins to the formation of Schnitzer Steel Products Company in the 1930's, which was formed to engage in the scrap iron and steel business. Schnitzer Investment Corporation, a real estate development and management business, was founded by the four Schnitzer brothers. Our company's real estate division has investments in office buildings, industrial parks, and apartments -- primarily in the Portland, Oregon; Seattle, Washington; and, San Francisco,

California metropolitan areas. The industrial operations are comprised of several million square feet of industrial, office, and warehouse space at various locations. Both Schnitzer Steel and Schnitzer Investment Corporation, as well as our Seattle Cold Storage Division, have grown into successful operations today, and continue to be owned and operated by members of my family. My family also has investments in both United States flag and foreign flag shipping businesses, and retail, industrial and real estate operations on the island of Guam.

Although not large by Wall Street standards, our company represents a true American success story, and a major investment and source of income for my family. The three surviving brothers now range in age from 69 to 86 years.

Our company elected to be taxed as an S Corporation for federal income tax purposes as of September 2, 1988. The founders and their spouses together own 34% of the outstanding stock of our company. Over the years, they have transferred stock ownership representing 54% to their 13 children, and 12% to 16 of their 23 grandchildren.

Under current United States income tax rules, an S Corporation is required to have no more than 35 shareholders. At the present time, Schnitzer Investment Corporation has a total of 33 shareholders. My family wishes to continue to provide stock ownership opportunities to all family members. Under current tax law, however, it is precluded from doing so.

The 13 children of the second generation presently range in age from 26 to 55 years. Four of those are active in management of the business. The 23 grandchildren currently range in age from nine months to 34 years old. All but three are under age 25.

Obviously, the first and second generations are hopeful that several of the grandchildren will, in the future, take active roles in the business. The older generations believe that providing the opportunity for significant stock ownership to all members of the younger generation is the most important aspect of developing an interest in the business. Developing such interest will become critical to the survival of our company as a Schnitzer family owned and operated business in the decades to come. Continuation of S Corporation status for income tax purposes clearly provides the most efficient way to have this business continue to grow and prosper.

I understand that the 35-shareholder limit is intended to ensure that the benefits of S status are limited to closely held businesses and not extended to large, widely held companies. My family is not alone in wanting to keep ownership of their business in the family. The limit puts us and many other businesses across the country in the difficult position of choosing between losing the benefits of S status, selling a portion or all of the business, or not leaving shares to some of the descendants. Each of these choices is undesirable and they achieve no tax policy benefit. The importance of family-owned businesses to this country should not be underestimated. At a time when small businesses are responsible for creating most of the jobs in this country, tax policy should not penalize families who want to keep ownership of the business in the family.

There are several ways to solve the 35-shareholder limit. Last year, thanks to the work of the Ways and Means Committee and yourself, Mr. Chairman, Congress approved H.R. 11 which included a provision to raise the Subchapter S shareholder limit from 35 to 50. This legislation, however, was vetoed by President Bush. This approach would certainly solve my family's immediate problem and the problem for other family businesses.

There may also be a broader and more permanent solution. I understand that Representative Shaw may propose a bill providing an exception to the 35-shareholder limit. This exception would apply where all the shares are owned by descendants (or their spouses) of a common ancestor. Businesses would qualify for S status no matter how many shareholders they had so long as all the shareholders were family members. On the other hand, the corporation could have no outside shareholders. Family ownership would thus be preserved while the integrity and original purpose of the 35-shareholder rule would remain in tact. This solution would provide a permanent remedy for the enlarged, third and fourth generation family situation. The Schnitzer family enthusiastically supports this approach and would strongly urge the Committee to consider this proposal as you prepare new tax legislation.

In closing, I would like to thank you, Mr. Chairman, and the Committee, for the opportunity to appear before you to discuss a matter of importance to my family and to family businesses across the nation.

Mr. HOAGLAND. Now we will go to the next panel, Panel Number 4, if those of you that are participating in Panel 4 could step forward.

Gentlemen, why don't we begin with Mr. Lovain; and then we will go to Mr. Harper and Mr. Capon—the two of you are testifying at the same time—and Mr. Contos; and then Mr. Millett; and finally, Mr. Girard. OK?

Mr. Lovain.

STATEMENT OF TIMOTHY LOVAIN, CHAIRMAN, TRADE TAXES GROUP

Mr. LOVAIN. Thank you, Mr. Chairman. I am Timothy Lovain, I work with Denny Miller Associates. We represent the Port of Tacoma, Wash., but I also chair the Trade Taxes Group, an informal association of organizations concerned about the recent increase in counterproductive taxes on trade.

I request that a whitepaper prepared by our group be inserted in the record after my testimony.

I am testifying today on legislative proposals pertaining to the harbor maintenance tax on behalf of the following: the American Association of Port Authorities, the National Industrial Transportation League, the Polaroid Corp., New England Shippers Advisory Council, American Great Lakes Ports, National Grain and Feed Association, the Bose Corp., the Maritime Department of Massport, and the Ports of Tacoma and Seattle.

Your subcommittee has asked for testimony on two harbor maintenance tax proposals, first, on the concept of suspending collection of the tax when the trust fund balance reaches a certain threshold amount—we strongly support that proposal—and second, using the harbor maintenance tax revenues for NOAA programs—we strongly oppose that proposal.

The harbor maintenance tax was instituted in 1986 as part of the Water Resources Development Act. It was quite controversial at the time. People were concerned about its effect on U.S. exports and U.S. ports. In fact, this committee's report on that bill said the following: "The tax rate is set at a level which the committee believes will not cause competitive or economic burdens on the ports or users. The committee emphasizes that it will very carefully review any future proposed increase or other expansion of this tax."

Despite these concerns, the tax was more than tripled 4 years later, 1990. And now we have a large and growing surplus. It reflects the problem of the burden that this tax imposes on exporters and on U.S. ports. It is a substantial part of the transportation costs of many exports. For bulk commodities, a few pennies a ton can make the difference in a sale, so it is a great burden on U.S. exports. And it also chases cargo away from U.S. ports to Canadian ports where no such tax is collected.

So we would like to see a reduction in the tax rate, or a restructuring of the tax; but that is not feasible, given budget constraints.

We do support the idea of capping the Harbor Maintenance Trust Fund at a reasonable level. Congressman McDermott has circulated a proposal to do that, based on provisions in the Oil Spill Liability Trust Fund and the Superfund. We understand there are

some agency concerns about this. We would be happy to consider changes to that proposal to ensure reasonable implementation.

But we have to get a handle on these taxes, and this proposal by Congressman McDermott is revenue neutral over the next 5 years.

The Treasury Department, in their testimony, said that one of the reasons they oppose it is because the excess of the trust fund balance could be taken care of through diversion to NOAA. That is not the problem. The problem is the tax burden, and the surplus merely reflects that tax burden. We oppose any diversion of funds from the Harbor Maintenance Trust Fund for other purposes, because it is a trust fund with a designated revenue source for a specific government program.

Once you start down that slippery slope of using a trust fund for things unrelated to its purpose, where do you stop? It would simply cause other agencies to come forward with other bright ideas for spending the trust fund, and we would just have upward pressure on the tax rates, not a constraint on the tax rates.

We would also like to point out that there are GATT problems with the Harbor Maintenance Trust Fund right now because of the surplus in the trust fund. A cap would help to resolve those GATT problems; diversion from the trust fund for other purposes would exacerbate that GATT problem. So we urge you to support a cap proposal and to oppose a diversion from the trust fund for purposes unrelated to harbor maintenance.

Thank you.

Mr. HOAGLAND. Thank you, Mr. Lovain.

[The prepared statement follows:]

TESTIMONY OF

TIMOTHY LOVAIN, CHAIR, TRADE TAXES GROUP

BEFORE THE SUBCOMMITTEE ON SELECT REVENUE MEASURES

OF THE HOUSE WAYS AND MEANS COMMITTEE

ON LEGISLATION PERTAINING TO THE HARBOR MAINTENANCE TAX

JUNE 22, 1993

Mr. Chairman and Members of the Subcommittee, I am Timothy Lovain of Denny Miller Associates. We represent the Port of Tacoma, Washington and I chair the Trade Taxes Group, an informal association of organizations concerned about the recent increase in counterproductive taxes on trade. I request that a white paper issued by the Trade Taxes Group on our concerns be made part of the record.

I am testifying today on legislative proposals pertaining to the harbor maintenance tax on behalf of: American Association of Port Authorities, National Industrial Transportation League, Polaroid Corporation, New England Shippers Advisory Council, American Great Lakes Ports, National Grain and Feed Association, Bose Corporation, Maritime Department of Massport and the Ports of Tacoma and Seattle.

You have asked particularly for testimony regarding two proposals: "(i) suspending collection of the tax when the trust fund balance reaches a certain threshold amount, and (ii) using tax revenues to support nautical charting and marine navigational safety programs and other activities of the National Oceanic and Atmospheric Administration." We strongly support the first proposal and strongly oppose the second proposal.

Overview. The Water Resources Development Act of 1986 imposed a controversial harbor maintenance tax of 0.04 percent of cargo value to pay for up to 40 percent of the harbor maintenance activities of the Army Corps of Engineers. The tax is paid by most shippers using federal channels and collected by the Customs Service. The tax was enacted after considerable debate and despite widespread misgivings about its impact on U.S. exports and U.S. ports.

In spite of these concerns, in 1990, the Bush Administration proposed raising the tax rate to 0.125 percent of cargo value to pay for up to 100 percent of harbor maintenance work (0.115 percent) and for extraneous activities of the National Oceanic and Atmospheric Administration (NOAA). Although no hearings were held on the proposal, the 1990 budget agreement approved the full tax rate increase but rejected the diversion of trust funds to NOAA.

Harbor Maintenance Trust Fund revenues are increasing faster than expenditures because of increased trade, stricter enforcement of the tax, relatively constant Corps harbor maintenance appropriations and the artificially high harbor maintenance tax rate set by the 1990 budget agreement. The excess in the Harbor Maintenance Trust Fund grew from $72.5 million at the beginning of FY 1992 to $120.9 million at the beginning of FY 1993 and is projected to grow to $187.9 million by the beginning of FY 1994.

The Clinton Administration has proposed providing up to $5 million annually from the Trust Fund to the Customs Service to enhance enforcement of the tax. We support this proposal. One result of stricter enforcement, however, is that the surplus in the Trust Fund will grow even faster.

This growing surplus is especially disturbing because the harbor maintenance tax harms the competitiveness of U.S. exports and U.S. ports.

Freight cost is an integral part of a U.S. product's price to a foreign purchaser. For U.S. bulk commodities in close-margin international markets, such as grain and coal, just a few pennies a ton can determine who makes a sale. Federal taxes are an increasingly large component of the cost of shipping U.S. exports abroad. A recent GAO study identified 117 federal taxes on trade, assessed by 12 different federal agencies, with total collections of $11.9 billion in FY 1991. When Customs duties are excluded, the harbor maintenance tax is probably the most burdensome and controversial of all of these taxes.

The harbor maintenance tax also diverts cargo from U.S. ports to Canadian and Mexican ports where no such tax is collected. U.S. ports in the Pacific Northwest, Great Lakes region and Northeast compete directly with nearby Canadian ports. When an average container ship loads or unloads cargo at a U.S. port, U.S. exporters, importers or shippers owe about $75,000 in harbor maintenance taxes; Canada does not impose such a tax. U.S. ports in California and the Gulf Coast face an increasing challenge from the incipient Mexican port development program.

When shippers can easily utilize either U.S. or neighboring foreign ports, the heavy burden of trade taxes, especially the harbor maintenance tax, make U.S. ports a less attractive option. The burden of the harbor maintenance tax weighs especially heavy on northern ports that face Canadian competition but need very little harbor maintenance.

Trust Fund Cap: The U.S. trading community would benefit greatly from a reduction in the harbor maintenance tax rate or a restructuring of the tax but, in light of current budget constraints, we are not proposing such changes. Placing a cap on the balance in the Trust Fund, however, would be an important first step in controlling the growing surplus in the Trust Fund and in ameliorating the deleterious effects of the harbor maintenance tax.

Congressman McDermott has circulated a cap proposal based on provisions in the Hazardous Substance Superfund and the Oil Spill Liability Trust Fund. It would provide that, if the unobligated balance in the Harbor Maintenance Trust Fund exceeds $100 million, the harbor maintenance tax would not be applied during the next calendar quarter. The Joint Committee on Taxation determined that the McDermott proposal would not result in a revenue loss within the current budget window. We commend Congressman McDermott for his leadership on this issue.

I understand that federal agencies are sympathetic to this proposal in principle but have suggested that it be modified to reflect the unique way the Harbor Maintenance Trust Fund operates. We would be amenable to any alternative proposals that would accomplish the same purpose of capping the surplus in the Trust Fund. The harbor maintenance tax should not be used to collect more money than is needed for harbor maintenance because of its adverse effects on the competitiveness of U.S. exports and U.S. ports.

NOAA Diversion: Any Trust Fund surplus also tempts lawmakers to use the Trust Fund for extraneous purposes. To do so, however, would violate the "trust" in the trust fund, negate the "user fee" principle of the harbor maintenance tax and invite other extraneous claims on the Trust Fund.

The Harbor Maintenance Trust Fund surplus has already drawn the attention of lawmakers interested in funding maritime reform, dredge disposal sites, and other programs unrelated to harbor maintenance. The most persistent proposed raid on the Trust Fund, however, is for NOAA's nautical charting and related programs.

The Bush Administration proposed diverting $45 million from the Trust Fund for this purpose in 1990 and again in 1992 but was rebuffed by Congress. The Clinton Administration has picked up this proposal this year and legislation to authorize this diversion has been introduced in both the House and Senate.

The Water Resources Development Act created the harbor maintenance tax and the Harbor Maintenance Trust Fund for the sole purpose of funding harbor maintenance---a designated revenue source for a specific federal activity. Once that principle is breached, once you start down the slippery slope of using harbor maintenance tax revenues for purposes other than harbor maintenance, where do you stop?

We support improved nautical charts, but they should be financed from the General Fund. The Harbor Maintenance Trust Fund should not be used as a slush fund for every federal activity related to ships and water.

Once the pernicious precedent of using the Harbor Maintenance Trust Fund for purposes other than harbor maintenance is introduced, other proposals will follow. Pressures will mount, not for a cap on the harbor maintenance tax, but for an increase to pay for all the new extraneous programs funded by the Trust Fund. The burden on the competitiveness of U.S. exports and U.S. ports will grow and grow.

Please don't start down that treacherous road.

GATT Concerns: The Committee should also examine both of these legislative proposals in the context of the General Agreement on Tariffs and Trade (GATT). The harbor maintenance tax may soon face a GATT challenge because of the growing surplus in the Trust Fund, because the federal government is collecting more than it needs for this designated purpose.

A cap on the Trust Fund would help address this potential GATT violation. A raid on the Trust Fund for spending unrelated to harbor maintenance, however, would increase the likelihood of a GATT challenge.

We urge you to approve a cap on the balance in the Harbor Maintenance Trust Fund and to reject all proposals to raid the Trust Fund for purposes unrelated to harbor maintenance.

Thank you for your attention to our views.

TRADE TAXES AND U.S. COMPETITIVENESS

A host of heavy new increases in U.S. trade taxes are threatening the international competitiveness of U.S. exports and U.S. ports. Among the new and/or sharply higher levies affecting trade are vessel tonnage taxes; harbor maintenance taxes; taxes on fuel for railway, truck and inland waterway transport; Coast Guard fees; and commodity inspection fees. The economic damage caused by these mounting taxes outweighs the benefits and in some cases may actually cause a loss in revenue through cargo diversions and lost sales of U.S. goods.

Most Americans are unaware of the unprecedented magnitude of the problem now posed for U.S. trade because of the cumulative effects of the taxes. With virtually no hearings on the trade impact, Congress adopted a number of the huge tax increases in its rush to raise revenue during the closing hours before adjournment of the 101st Congress last fall. For example, as part of the Omnibus Budget Reconciliation Act of 1990, Congress boosted the harbor maintenance tax by 212 percent, from .04 to .125 percent of cargo value, and hiked the vessel tonnage tax by 350 percent, from 6 to 27 cents per ton for most ships. These are taxes on domestic and international trade because the water carriers in most cases pass their costs on to the commodity shippers. And since 95 percent of U.S. international trade travels by sea through U.S. ports, they are taxes on almost all U.S. exports.

Exports today are increasingly necessary to the health of America's economy, especially as we try to pull out of a recession. One out of six U.S. manufacturing jobs can be linked to exports and more than one-third of major U.S. grain crops are exported. Exports accounted for 90 percent of U.S. GNP growth last year.

The Administration and Congress recognize that U.S. export growth is essential for business and jobs, reduction of our excessive trade deficit, and the future of the U.S. in the global economy, and have called for stepping up U.S. competitiveness. Yet the new trade taxes cause increased prices for U.S. exports and/or reduced prices paid to U.S. producers. They have also increased the cost of using U.S. ports, thereby encouraging the diversion of cargoes from U.S. to foreign ports. Together, these effects mean a decline in U.S. competitiveness, income and jobs.

Too few people realize that freight cost is an integral part of a U.S. product's price to a foreign purchaser, and what a difference it can make on closely competitive items. For U.S. bulk commodities in close-margin international markets, such as grain and coal, just a few pennies a ton can determine who makes a sale. The new trade taxes have increased the cost of shipping a ton of wheat by about 30 cents, and a ton of coal by about 47 cents.

U.S. export cargoes are especially impacted by the harbor maintenance tax, which adds to the comparative tax disadvantage of U.S. ports competing with foreign ports. American ports in the North Pacific, Great Lakes and North Atlantic ranges engage in intense, direct competition for cargo with Canadian ports. For instance, when an average container ship loads or unloads cargo at a U.S. port, U.S. exporters, importers or shippers owe about $75,000 in harbor maintenance taxes and the carrier owes about $5,400 in vessel tonnage taxes. By comparison with this at least $80,000 for the ship at the U.S. port, Canada has no national taxes or fees (except for a nominal drug interdiction fee paid by the consignee). Transshipment of U.S. exports and imports through Canadian ports increased 60 percent from 1986 to 1988. This trend is likely to grow as much higher U.S. trade taxes affect the port selections of exporters, importers, shippers and carriers. And for each sale that is lost to a foreign supplier or diverted to a foreign port, the U.S. Treasury gets no trade tax revenue at all.

Ironically, the government itself is paying subsidies to help exports of some U.S. goods, such as farm commodities, in the face of tough foreign competition. The trade tax increases apply against most of these same products whose export the government is trying to promote.

In hurriedly imposing the steep tax increases without hearings on their trade impact, Congress made little pretense of sticking to previously agreed user fees. The purpose was to raise revenue: about a half billion dollars annually from the harbor maintenance tax and $68 million from the vessel tonnage tax. This is on top of more than $12 billion that U.S. customs already collects from cargoes going through American ports. In actuality, the real revenue increase from the new taxes may be reduced because of their negative economic impact, and the income for U.S. exporters of competitive goods certainly will be lessened because of these taxes.

In sum, the trade taxes are harmful to U.S. export competitiveness. They will cost U.S. jobs and business. Their revenue projections are dubious. The undersigned organizations oppose the continuation of the trend toward greater reliance on trade taxes. Congress and the Administration should examine the negative effects of these taxes and reduce or eliminate them where appropriate.

Agriculture Ocean Transportation Coalition
American Association of Exporters and Importers
American Association of Port Authorities
American Farm Bureau Federation
American Federation of Grain Millers, Local 118
American Great Lakes Ports
American Institute of Merchant Shipping
American Soybean Association
American Waterway Operators
Anamax Corporation
Association of International Automobile Manufacturers
Burns International Harbor
Cargill, Inc.
Coal Exporters Association
ConAgra, Inc.
Continental Grain Company
Degussa Corporation U.S.A.
Duluth-Superior Marine Association
Foreign Trade Association of Southern California
Guthrie-Hubner, Inc.
Illinois International Port/Chicago
Inland Rivers Ports and Terminals, Inc.
International Mass Retail Association
Leicht Material Handling, Inc.
Louis Dreyfus Corporation
Massachusetts Port Authority
Meehan Seaway Service, Ltd.
Millers National Federation
Minnesota Agri-Growth Council
Minnesota Association of Wheat Growers
Mitsui Grain Corporation
Motor Vehicle Manufacturers Association of the U.S.
National Association of Stevedores
National Association of Wheat Growers
National Coal Association
National Corn Growers Association
National Customs Brokers & Forwarders Association of America, Inc.
National Grain and Feed Association
National Grange
National Industrial Transportation League
National Waterways Conference, Inc.
North American Export Grain Association
Philadelphia Regional Port Authority
Port of Cleveland
Port of Corpus Christi
Port of Everett
Port of Green Bay
Port of Houston Authority
Port of Los Angeles
Port of New Orleans
Port of Kalama
Port of Longview
Port of Milwaukee
Port of Portland
Port of Redwood City
Port of Seattle
Port of Tacoma
Seaway Port Authority of Duluth
Shippers for Competitive Ocean Transportation
Svensson Shipping Agency, Inc.
The Port Authority of New York and New Jersey
Toledo-Lucas County Port Authority
Union Equity Cooperative Exchange
U.S. Great Lakes Shipping Associations
Woodhouse Corporation

Mr. HOAGLAND. Mr. Harper, representing the Association of American Railroads.

STATEMENT OF EDWIN L. HARPER, PRESIDENT AND CHIEF EXECUTIVE OFFICER, ASSOCIATION OF AMERICAN RAILROADS

Mr. HARPER. Thank you very much, Mr. Chairman. The Association of American Railroads strongly opposes proposals to require freight railroads and their customers to subsidize passenger railroad service in this country by sending fuel taxes to an intercity rail passenger capital improvement trust fund.

The restoration of the financial health and independence of America's freight railroads has been achieved over the last 20 years due to the Staggers Act, which partially deregulated the railroads, and legislation such as the National Rail Passenger Act of 1971, which eliminated cross-subsidization of passenger losses from freight revenue. The freight railroads are willing to cooperate with those interested in promoting rail transportation, but cannot risk making freight services less cost effective. American freight railroads must raise and invest more than $3 billion a year for their own infrastructure expenses.

The industry as a whole already faces a shortfall without having to finance rail passenger services as well. It would be unfair to ask freight railroads and their customers, the shippers of grain, coal, paper, forest products, chemicals, automobiles and a host of other manufactured products to subsidize intercity passenger service. The beneficiaries of rail passenger service are the railway passengers and highway users who benefit from reduced congestion, not freight railroads and their shippers.

Intercity rail passenger service has many more funding sources available to them than do the freight railroads. Let me give you four examples. One, intercity and commuter rail services can depend on Federal, State and in some cases local appropriations. Secondly, they have available tax-exempt financing. Third, assistance could be available through the Intermodal Transportation Efficiency Act of 1981; and fourth, potential assistance may be gained through legislation recently introduced by the administration promoting high-speed rail passenger service in this Nation.

Finally, any discussion of the railroads and taxes should reflect upon current legislation. Part of the rationale of the tax legislation crafted by the House and the Senate is to encourage fuel efficiency. Unfortunately, the net result of the provisions will be to penalize the most fuel-efficient mode of freight transportation, the railroads, by asking them to pay 2.5 cents per gallon more toward deficit reduction than their major competitors.

Is this fair? Is it good public policy? We believe not, and we ask your help in remedying this inequity.

Thank you, Mr. Chairman.

Mr. HOAGLAND. Thank you, Mr. Harper.

[The prepared statement follows:]

STATEMENT OF EDWIN L. HARPER,
PRESIDENT OF ASSOCIATION OF AMERICAN RAILROADS

Mr. Chairman, and Members of the Subcommittee, I am Edwin L. Harper, President and CEO of the Association of American Railroads (AAR)[1], and I welcome the opportunity to provide the subcommittee with the perspective of America's freight railroads on the proposal to establish an Intercity Rail Passenger Capital Improvement Trust Fund with receipts from the "deficit reduction rate" (federal motor fuel excise tax) paid by freight railroads.

The AAR strongly opposes this proposal because our industry has been indelibly impressed with the disastrous consequences of previous national practices where the nation's freight railroad system subsidized passenger service around the country. That era ended with the enactment of the National Railroad Passenger Act of 1971, and our members do not want to start down that road again.

We urge the subcommittee to rely on existing funding sources for intercity rail passenger service, rather than proceeding with a trust fund that depends on the freight rail segment for funding.

In opposing this proposal, the AAR and its member roads are aware of the public interest in, and the potential public benefits from rail passenger service. Indeed, the freight railroad industry shares with rail passenger services many attributes -- reduction of congestion, safety, environmental attractiveness, and energy conservation -- that make railroads so appealing today.

The freight railroad industry has worked with various levels of governments and sponsors of passenger rail service to enable the operation of passenger service. This has included both Amtrak, the nation's intercity rail passenger service, and numerous commuter operators. Most recently, the AAR and Amtrak jointly issued a policy statement on high-speed rail service. That statement, which is attached, outlines the essential principles and conditions to the operation of high-speed rail on the private freight rail system.

The position of the AAR on this matter is consistent with transportation policy set over the last two decades, including:

> --**The Rail Passenger Service Act of 1970,** which established AMTRAK, a government-owned national passenger railroad.[2] Freight railroads were no longer required to be in the passenger business, and transferred their passenger equipment to AMTRAK at that time along with significant cash payments;
>
> --**The Staggers Rail Act of 1980,** which established for the freight rail industry the goal of providing a safe and efficient rail transportation system to meet the needs of interstate commerce and a national defense while earning sufficient revenues to remain viable in the private sector,[3] and;
>
> --**The Northeast Rail Service Act of 1981,** which took Conrail out of the business of providing commuter rail services in numerous states.[4]

These legislative actions were designed to relieve freight railroads of the burdens passenger service placed on them, subsidies so large they were the main reason for the insolvencies of some railroads.

More recently, Congress passed "The Intermodal Surface Transportation Efficiency Act of 1991." The Association of American Railroads fully endorses the national transportation policy established by ISTEA, and the need for broad goal-oriented multimodal transportation planning by all levels of government.

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[1] The Association of American Railroads represents the nation's freight railroad systems, and AMTRAK. These roads comprise 92% of the route miles operated in the United States and they carry 90% of the nation's freight.
[2] 84 Stat. 1327 (1970).
[3] 94 Stat. 1895 (1980).
[4] 95 Stat. 357 (1981). NERSA was contained in the Budge Reconciliation Act of 1981.

President Clinton and the Department of Transportation have recently unveiled legislation to promote the establishment of high-speed rail corridors in this nation, and the AAR is working with all interested parties to facilitate that objective.

FUEL TAXES AND RAILROADS

Historically, the federal motor fuels excise tax has been considered a "user fee" where highway users paid the tax, and the receipts were devoted to the Federal Highway Trust Fund. Because railroads are not users of the highways and because they finance, build, and maintain their own rail network they rightfully have not been asked to pay this excise tax.

In 1990 Congress deviated from this policy and applied a 2.5 cents-per-gallon federal diesel fuel excise tax to railroads after imposing a similar tax on highway diesel fuel (trucks) and gasoline. This 2.5 cents-per-gallon "deficit reduction rate" collected from railroads, truckers, and gasoline-users does not go the Highway Trust Fund, but to the general fund for deficit reduction purposes. Under current law this "deficit reduction rate" is due to expire September 30, 1995.

Several proposals have surfaced this year that would in large part return the federal motor fuels excise tax back into a "user fee." H.R. 2264, the "Omnibus Budget Reconciliation Act of 1993," as reported by the Ways and Means Committee and passed by the House of Representatives, would not deposit the 2.5 cents-per-gallon component of the 1990 fuels tax increase paid by highway users to the general fund after September 30, 1995, but would re-direct it to the Highway Trust Fund -- leaving railroads in the inequitable position of having to pay for deficit reduction, while a major competitor --the trucking industry-- would derive significant and substantial benefit through infrastructure improvements from the Highway Trust Fund.

WHAT TO DO ABOUT THE RAILROAD "DEFICIT REDUCTION RATE?"

Congress was clear in its intent in 1990 that railroads should only be required to pay a federal excise tax on diesel fuel in the same amount the trucking industry contributed to deficit reduction-- and that no railroad taxes would be deposited in the Highway Trust Fund. Railroads are prepared to live with this current law arrangement without change, and in fact that principle seems to be the basis for the current consideration of a transportation fuels tax in the Senate as an alternative to the Btu tax.

The freight railroad industry is troubled that the Congress has not properly considered a major inequity that results from the fact that railroads would be required to pay two deficit reduction taxes. Confronted with deficit taxes that are nearly 60 percent higher than their competitors, railroads will be disadvantaged in competing with less fuel efficient trucks. One objective of the new energy tax is to reduce the deficit while encouraging fuel conservation; however, the legislation unfortunately penalizes the most fuel efficient transportation mode.

The fate of the 1990 "deficit reduction rate" paid by railroads must not be overlooked as Congress reworks and rewrites the statutes governing motor fuels excise taxes and transportation taxes.

It is neither fair nor appropriate that the railroad "deficit reduction rate" be deposited in the Highway Trust Fund. Nor is it appropriate or fair for the railroad "deficit reduction rate" to be used to fund an "Intercity Rail Passenger Capital Improvement Trust Fund" for the reasons I have stated. If the Congress adopts a general transportation tax whose proceeds are dedicated toward deficit reduction, railroads will be part of that deficit reduction effort. At the same time, as a matter of fundamental fairness, the existing 2.5 cents-per-gallon "deficit reduction rate" should be allowed to expire as scheduled under current law. Alternately, if the Congress decides another course must be taken there are a number of ways the energy/transportation tax and the "deficit reduction rate" paid by railroads can be coordinated without creating an inequity for railroads. The AAR would be pleased to work with you toward this end.

Thank you.

HIGH-SPEED RAIL PASSENGER AND FREIGHT SERVICES:

OPPORTUNITIES FOR PARTNERSHIP

A
Policy Statement
of the
American Railroad Industry

1) Rail transportation offers America significant economic, environmental and safety benefits, and is a solution to increasing highway congestion.

2) America's freight railroads are ready to cooperate in the extension and advance of high-speed rail passenger service, as well as in other rail passenger services.

3) There are distinct types of passenger services: commuter, conventional intercity (Amtrak), high-speed and ultra high-speed. These differences must be understood because they control the extent to which rail freight and passenger operations can operate over the same rights-of-way.

4) In general, ultra high-speed rail service (over 150 miles-per-hour) cannot operate compatibly on the freight railroads' rights-of-way. There are fewer limitations on high-speed service (up to 150 mph), but strict safeguards are necessary. Freight railroads already accommodate conventional Amtrak service and viable partnership arrangements normally are possible. The same is true in most commuter areas. Essentially, partnership possibilities must be examined on a case-by-case basis.

5) The formation of partnerships among railroads and sponsors of new passenger rail projects will benefit the public.

6) The full costs of changes in existing freight rail operations to accommodate new passenger operations must be borne by the entity sponsoring the new service.

7) Freight railroads must be indemnified and insured against any and all financial liability arising from accidents affecting passenger services.

Association of American Railroads
January 25, 1993

Mr. HOAGLAND. Mr. Capon, representing the National Association of Railroad Passengers.

STATEMENT OF ROSS CAPON, EXECUTIVE DIRECTOR, NATIONAL ASSOCIATION OF RAILROAD PASSENGERS

Mr. CAPON. Thank you, Mr. Chairman. The organizations supporting my testimony include, besides the Sierra Club and the nine-State rail passenger associations listed in my written statement, the Friends of the Earth, the Philadelphia-based Clean Air Council and State rail passenger associations in Arkansas, Delaware, Iowa, Missouri-Kansas, New Jersey and Pennsylvania.

We appear in support of the proposal to authorize deposit of 1 cent on the tax on diesel fuel used by railroads into an Intercity Rail Passenger Capital Improvement Trust Fund through 1998. I will discuss separately the need for the trust fund and the funding issues.

Today, States and localities can leverage Federal dollars for highway and aviation investments fairly easily. Indeed, the Federal Highway Program is so attractive that, primarily due to State and local expenditures, spending on roads exceeds road-user payments by $20.5 billion a year, but only a few isolated pockets of Federal dollars are available to match State and local investments in intercity rail passenger improvements, unfortunately, not including the surface transportation program (STP) of ISTEA. Senate-passed language allowed the use of STP funds but did not survive to the Senate-House conference.

The basic Federal message to States and localities is, if you want to build roads and airports, we will pay a big share of the cost, usually 80 percent. If you want better Amtrak service, you are on your own. This is unfortunate, because when State legislators consider transportation spending, they want to know how many Federal dollars would be leveraged by a given amount of investment in various possible transportation projects.

This is also unfortunate in light of the important Federal objectives that would be served by more investment in rail passenger service. I have listed five on page 2 of my statement: better utilization of existing mass transit; better mobility for nondrivers; better utilization of existing rail infrastructure, reducing pressures for costly new airports or runways, for example; more reliability in transportation, because trains are less vulnerable to weather delays than other modes; and more energy efficiency, since, according to Oak Ridge National Laboratory figures, certificated airlines averaged 1.8 times more energy consumed per passenger mile than Amtrak in 1990.

President Clinton has committed his administration to develop a cost-effective program to reduce greenhouse gas emissions to 1990 levels by the year 2000. The freight railroads expect to make a positive contribution to that effort—consuming less energy in 2000 than in 1990—but it is going to take expansion of rail passenger service and improvements in other parts of the economy to meet the President's goal.

We suggest that perhaps half of any intercity rail passenger trust fund be available to States, the balance to be controlled by Amtrak.

Now let me talk about funding. Obviously, our first choice was reflected in last year's H.R. 4414, introduced by Representative Al Swift, which would have earmarked 1 penny of the entire deficit reduction rate, 2.5 cents, for creation of this fund. That would eliminate the need to spend any general funds on rail passenger capital expenses.

The current capital investment in rail passenger service, encompassing both Amtrak and the Northeast Corridor Improvement Project, is about $380 million. Needs have been identified around the $500 million level.

Perhaps our biggest single disappointment with the new administration, not unlike Mr. Harper's, was that it quickly endorsed returning the highway portion of the 2.5 cents for Federal deficit reduction to the Highway Trust Fund, while the railroads would see their 2.5 cents continue to go to deficit reduction. The irony is particularly strong because, as you are aware, the energy efficiency of the railroads is greater than of the highway modes.

We think the present proposal makes sense, given the importance of establishing the proposed trust fund and the unlikelihood that the railroads will be excused from paying this tax. Indeed, we would favor putting all of the railroads' 2.5 cents into the trust fund, producing income of about $80 million a year instead of $30 million.

In an ideal world, where it would be possible to turn off a tax, we would argue for an all-mode transportation trust fund, noting, similar to Mr. Harper's comment, that effective diversion of the aero-ticket taxes to trains would benefit air travelers if the result is more people on trains and less pressure on congested air facilities.

Back to the real world. A possible compromise with the freight railroads would be to restrict funds they pay to infrastructure improvements with some freight benefits as well as passenger benefits. From our standpoint, the important thing now is to get the proposed trust fund established. We can work later on ways to better fund it.

Thank you very much for your time.

Mr. HOAGLAND. Thank you, Mr. Capon.

[The prepared statement follows:]

Statement of

Ross Capon

Executive Director

National Association of Railroad Passengers

Before the Subcommittee on Select Revenue Measures

Committee on Ways and Means

U. S. House of Representatives

Intercity Rail Passenger Capital Improvement Trust Fund

June 22, 1993

Thank you for this opportunity to present the views of our non-profit organization. This testimony is also endorsed by the Sierra Club and by the following independent rail passenger organizations:

o Train Riders Association of California ("TRAC")
o Illinois Association of Railroad Passengers
o TrainRiders/Northeast (based in Portland, Maine)
o Empire State Passengers Association (NY)
o Ohio Association of Railroad Passengers
o Oregon Association of Railroad Passengers
o Virginia Association of Railway Patrons
o Washington (State) Association of Railroad Passengers
o Wisconsin Association of Railroad Passengers

We support the "proposal to authorize the deposit of 1 cent of the tax on diesel fuel used by railroads into an Intercity Rail Passenger Capital Improvement Trust Fund through 1998." What follows are separate discussions of the need for the trust fund, and of funding issues.

I. NEED FOR AN INTERCITY RAIL PASSENGER CAPITAL IMPROVEMENT FUND

Today, states and localities can leverage federal dollars for highway and aviation investments fairly easily. Indeed, the federal highway program is so attractive that, primarily due to state and local expenditures, spending on roads exceeds road user payments by $20.5 billion a year (Highway Statistics 1991, U.S. DOT, Table HF-10).

In contrast, only a few isolated pockets of federal dollars are available to match state/local investments in intercity rail passenger improvements. In 1991, we had higher hopes. The Senate approved language making such investments eligible for ISTEA Surface Transportation Program funds. This provision fell in conference, a victim of committee jurisdictional problems in the House.

ISTEA Section 1010 funds rail/highway grade-crossing work in designated corridors but only to the tune of $5 million a year. Pres. Clinton's FY '94 budget includes $96 million for a corridor assistance program, but this again is limited to a few key corridors and funding prospects are uncertain--the House Appropriations Subcommittee on Transportation included nothing for this in its FY '94 DOT appropriations bill. Sometimes a state can work out a cost-sharing deal with Amtrak, but further new deals are unlikely now because Amtrak's finances are stretched so taut that Pres. W. Graham Claytor Jr. for the first

time endorsed a supplemental appropriation for Amtrak. (The Amtrak Board, including Republican National Chairman Haley Barbour, wrote to Congress in support of the supplemental.)

However, the basic federal message to states and localities is: if you want to build roads and airports, we'll pay a big share of the cost (usually 80%); if you want better Amtrak service, you're on your own.

This is unfortunate, in light of the important federal objectives that would be served if the federal government truly encouraged states to invest in improved intercity rail passenger services. Such investments would mean better:

o utilization of existing public ground transportation services of all types, since rail generally offers better linkages with urban transit hubs than do airports;

o mobility for non-drivers--the young, the disabled, and the elderly--the latter in particular a growing segment of the population whose growth will become more rapid when the "baby-boomer" generation hits retirement;

o utilization of existing infrastructure, since, for example, greater use of underutilized rail lines can reduce pressures for costly new airports or runways which in any event are encountering strong opposition due to neighborhood and environmental concerns;

o reliability for business (and other travelers) as trains, particularly in corridor service, are far less vulnerable to weather delays than other modes of transportation; and

o energy efficiency, since Oak Ridge National Laboratory figures indicate certificated airlines averaged 1.8 times more energy consumed per passenger-mile than Amtrak in 1990 (Transportation Energy Data Book, table 2.13).

President Clinton has committed his Administration to develop a cost-effective program to reduce greenhouse gas emissions to 1990 levels by the year 2000. I was privileged to participate June 10-11 in a "commercial transportation workshop," part of the White House Conference on Global Climate Change, where the single best piece of news was a strong indication from freight railroad industry representatives that their industry will beat the President's target. (This is consistent with Oak Ridge data, which shows total railroad energy consumption declining while ton-miles increase.)

But the U.S. as a whole cannot meet the President's target on the strength of the rail freight industry's showing, given expansion of less energy-efficient modes, especially automobiles. Hence the importance of emphasizing another energy-efficient mode--intercity passenger rail.

Finally, referring again to Amtrak's difficult financial situation, any increase in state/local Amtrak-related investments could be seen as reducing pressure for federal investment in Amtrak and could help create the strong partnership among different levels of government evident with the other modes.

Thus we suggest that perhaps half of any intercity rail passenger trust fund be available to states on a matching-funds basis, the balance to be controlled by Amtrak.

II. FUNDING SOURCES

Obviously our first choice was reflected in last year's H.R. 4414, introduced by Rep. Al Swift (D-WA), which would have earmarked one penny of the entire "deficit-reduction 2.5-cents."

That penny--approximately one billion dollars--would have eliminated the need to use any general funds on rail passenger capital expenses.

[In FY '92, federal capital appropriations were $175 mill. for Amtrak nationwide and $205 mill. for the Northeast Corridor Improvement Project, with $150 mill. of the latter figure earmarked for the effort to create Boston-New York three-hour service by 1997.]

[Amtrak requested $300 mill. in nationwide capital for FY '93 (and received $165 mill.), calling this request "absolutely essential to the long-term future of Amtrak and our ability to provide reliable, quality service at less operating cost to the federal government."]

Perhaps our biggest single disappointment with the new administration was that it quickly endorsed returning the highway portion of that 2.5 cents to the Highway Trust Fund, while the railroads (including, incidentally, Amtrak and commuter railroads) would see their 2.5 cents continue to go to deficit reduction.

This was particularly ironic because it was the truck lobby that roped railroads into the 1990 tax in the first place; now if the administration gets its way the truckers will be excused from deficit reduction and the railroads continue to pay. (When asked at the DOT budget briefing why the railroad tax wasn't simply dropped, Kathy Collins, DOT's budget expert, said: "It's hard to turn off a tax.")

We think the present proposal makes sense, given the importance of establishing the proposed trust fund and the unlikelihood that the railroads will be excused from paying this tax. Indeed, we would favor putting all 2.5 cents into the trust fund, producing income of about $80 million a year instead of $30 million. Beyond that, of course, lies the Senate Finance Committee's recent proposal of a per-gallon transportation tax--or at least the railroad portion of it--which at 4.3 cents would be about $130 million. Even this sum is less than half the needs Amtrak has identified.

We recognize the railroad industry's unhappiness with this approach. Indeed, in an ideal world where it would be possible to "turn off a tax," we would argue for an all-mode transportation trust fund noting, for example, that effective diversion of air ticket taxes to trains would benefit air travelers if the result is more people on trains and less pressure on congested air facilities.

Back to the real world. A possible compromise with the freight railroads would be to restrict funds they pay to infrastructure improvements with some freight as well as passenger benefits.

The most important thing now is to get the proposed trust fund established. We can work later on ways to get more money into it.

# # #

Mr. HOAGLAND. Mr. Contos.

STATEMENT OF LARRY CONTOS, MEMBER, BOARD OF DIRECTORS, NATIONAL GROCERS ASSOCIATION, AND PRESIDENT AND CHIEF EXECUTIVE OFFICER, PAY LESS SUPERMARKETS, INC., ANDERSON, IND.

Mr. CONTOS. Mr. Chairman and members of the committee, I am Larry Contos, president and chief executive officer of Pay Less Supermarkets in Anderson, Ind. I am accompanied by Tom Wenning of the National Grocers Association. Pay Less consists of nine full-service supermarkets, which sell beer and wine.

I also serve as a member of the executive committee of the National Grocers Association, on whose behalf I am testifying today.

I am a part-owner of nine Sizzler restaurants, which sell beer and wine.

The National Grocers Association is a national trade association representing the interests of independently owned retail and wholesale grocers, who comprise the independent sector of the grocery industry. NGA membership represents the owners and operators of more than 50,000 stores, including supermarkets, convenience stores, warehouse stores, and super stores. This sector of the grocery industry accounts for almost half of the $382 billion in grocery industry resales in the United States.

In 1987, the increase in the special occupational tax, SOT, adversely affected our members, unfairly penalizing them for back taxes, penalties and interest. In response, NGA, the National Association of Convenience Stores (NACS) and other organizations formed a coalition for its repeal in 1988. NGA, NACS, and the other coalition members have testified numerous times in favor of repeal—at hearings in April of 1991 and as part of a tax simplification hearing in July 1991.

I am here today to request your continued support for repeal of the special occupational tax on alcoholic beverage dealers.

Ever since its enactment, which was without public hearings, and at the last minute in the 1987 Omnibus Budget Reconciliation Act, NGA and members of the special occupational tax coalition have strongly urged prompt and complete repeal of the special occupational tax. In 1992, the Ways and Means Committee approved repeal of the SOT. However, H.R. 5649's repeal was narrowly rejected by the House, 200–207. The repeal was only rejected by the House because of the revenue offset's adverse effect on farmers. Throughout the floor debate, many Members of Congress who spoke, even those opposing the bill, voiced their support for repealing this tax, which is imposed upon every business outlet who sells or dispenses alcoholic beverages.

This year NGA and the occupational tax coalition are joining to support Representative Mike Kopetski's efforts to repeal the special occupational tax in the 103d Congress. For a number of reasons the repeal of the unnecessary and duplicative tax is long overdue.

The tax was passed as a part of the 1987 act without any hearings or opportunity for public examination.

Since 1987 the Bureau of Alcohol, Tobacco and Firearms has taken the position that the Tax Code does not limit past liability. As a result, many grocers have unfairly been found liable for back

taxes, penalties and interest for all the years in which they sold alcohol, sometimes for more than a decade.

The General Accounting Office has indicated that the special occupational taxes are cumbersome and costly for the BATF to administer and has endorsed repeal. The elimination of the SOT tax would eliminate the tremendous bureaucracy that is engaged in attempting to collect relatively small amounts of revenue from an estimated 550,000 to 750,000 retail establishments nationwide. This list includes grocery stores, convenience stores, restaurants, hotels, motels, florists, campground owners, petroleum marketers, community service groups and even fraternal organizations. Repeal of the SOT would automatically eliminate both the mechanical complexity and record keeping requirements for hundreds of thousands of businesses.

As it stands today, this tax is the only reason any retailer of alcoholic beverages ever comes into contact with the BATF. There is no gap created by eliminating this tax.

In conclusion, Mr. Chairman and members of the committee, on behalf of the National Grocers Association and other members of the Special Occupational Tax Coalition, we strongly encourage you to proceed as expeditiously as possible to repeal this outdated, inefficient and nonessential tax. Thank you for the opportunity to present our views and work within the democratic process.

Mr. HOAGLAND. Thank you, Mr. Contos.

[The prepared statement follows:]

TESTIMONY OF

NATIONAL GROCERS ASSOCIATION

PRESENTED BY LARRY CONTOS

PRESIDENT AND CHIEF EXECUTIVE OFFICER

OF PAY LESS SUPER MARKETS, INC. BEFORE

HOUSE WAYS AND MEANS COMMITTEE

SUBCOMMITTEE ON SELECT REVENUE MEASURES

JUNE 22, 1993

Mr. Chairman and members of the committee, I am Larry Contos, President and Chief Executive Officer of Pay Less Supermarkets, Inc. in Anderson, Indiana. Pay Less consists of nine full-service supermarkets which sell beer and wine. I also serve as a member of the executive committee of the National Grocers Association, on whose behalf I am testifying today.

The National Grocers Association is a national trade association representing the interests of independently owned retail and wholesale grocers who comprise the independent sector of the grocery industry. The N.G.A. membership represents the owners and operators of more than 50,000 stores, including supermarkets, convenience stores, warehouse stores and super stores. This sector of the grocery industry accounts for almost half of the $382 billion dollars in grocery industry sales in the United States.

In 1987, the increase in the Special Occupational Tax (SOT) adversely affected our members, unfairly penalizing them for back taxes, penalties and interest. In response, N.G.A., the National Association of Convenience Stores (NACS) and other organizations formed a coalition for its repeal in 1988. N.G.A., NACS and other coalition members have testified numerous times in favor of repeal at oversight hearings in April 1991 and as part of tax simplification hearings in July 1991. I am here today to request your continued support for repeal of the Special Occupational Tax on alcoholic beverage dealers.

Ever since its enactment (without public hearings and at the last minute) under the 1987 Omnibus Budget Reconciliation Act, N.G.A. and members of the Special Occupational Tax Coalition have strongly urged prompt and complete repeal of the Special Occupational Tax. In 1992, the Ways and Means Committee approved repeal of the SOT. However, H.R. 5649's repeal was narrowly rejected by the House of Representatives 200 to 207. Repeal was only rejected by the House because of the revenue offset's adverse effect on farmers. Throughout the floor debate, many members of Congress who spoke (even those opposing the bill) voiced their support for repealing this tax, which is imposed upon every business outlet that sells or dispenses alcoholic beverages.

This year, N.G.A. and the Occupational Tax Coalition are joining to support Representative Mike Kopetski's efforts to repeal the Special Occupational Tax in the 103rd Congress. For a number of reasons, the repeal of this unnecessary and duplicative tax is long overdue.

1. The tax was passed as part of the 1987 Act without any hearings or opportunities for public examination.

2. Since 1987, the Bureau of Alcohol, Tobacco and Firearms (BATF) has taken the position that the tax code does not limit past liability. As a result, many grocers have unfairly been found liable for back taxes, penalties and interests for all the years in which they sold alcohol, sometimes for more than a decade.

3. The General Accounting Office has indicated that the special occupational taxes are cumbersome and costly for the BATF to administer and has endorsed repeal. The elimination of the SOT tax would eliminate the tremendous bureaucracy that is engaged in attempting to collecting relatively small amounts of revenue from an estimated 550,000 to 750,000 retail establishments nationwide. This includes grocery stores, restaurants, hotels and motels, florists, campgrounds owners, petroleum marketers, community service groups and even fraternal organizations, such as the Veterans of Foreign Wars, Knights of Columbus, the Polish American League, the Elks, and the American Legion.

4. Even the BATF director, Stephen Higgins, has explained the inefficiency of this tax by acknowledging that "the SOT is collected from members of the industry with whom we otherwise have little or no contact. Retailers are not required to have federal licenses or permits." Because of this, SOT taxpayers are difficult to identify, and man-hours are being used in an often futile attempt to identify unknown taxpayers when they could be better directed to more significant BATF enforcement endeavors.

5. Repeal of the SOT would automatically eliminate both mechanical complexity and record keeping requirements for hundreds of thousands of businesses. As it stands today, this tax is the only reason any retailer of alcoholic beverage ever comes into contact with BATF. There is no gap created by eliminating the tax.

In conclusion, Mr. Chairman and members of the Committee, on behalf of the National Grocers Association and other members of the Special Occupational Tax, we strongly encourage you to proceed as expeditiously as possible to repeal this outdated, inefficient and non-essential tax. Thank you for the opportunity to present our views and work within the democratic process.

Mr. HOAGLAND. Mr. Millett.

STATEMENT OF DAVID G. MILLETT, TAX MANAGER, IRECO INC., DYNO NOBEL INC., SALT LAKE CITY, UTAH

Mr. MILLETT. Yes, Mr. Chairman, I would like to thank you and Congressman Goodlatte, sitting to my left, for this opportunity I have to represent the explosives industry. Explosive handling vehicles which we are discussed in this legislation are designed to safely and economically manufacture explosives. Explosive ingredients are stored in separate compartments on these vehicles in a nonexplosive state. At the blast site these vehicles load and mix the explosive ingredients into predrilled boreholes. The primary consideration in the design of these vehicles is safety and manufacturing, not transportation.

The explosive industry is not seeking special treatment, only fair treatment. The exemption sought in this legislation is the same exemption that has been granted to other industries. The heavy truck tax is to compensate the government for the additional wear and tear these vehicles have on public roads. The explosive industry agrees with this rationale and is paying the excise tax on the chassis portion of these vehicles. This tax averages between $7,000 to $10,000 per chassis.

As I mentioned, these units are designed to safely and economically manufacture explosives, not transportation. Therefore, they will only average between 60,000 to 70,000 miles during the life of the equipment. In addition, the explosive industry estimates that 70 percent of all explosive handling vehicles operate totally off road and are never on public roads. When comparing the amount of excise tax paid on a usage basis, the explosive industry is currently paying 30 times the amount of Federal excise tax that the trucking industry is paying. This legislation will directly impact over 240 companies located in 42 States, as well as indirectly impact mining, construction, and quarrying industries as well as consumers of products that are acquired or manufactured with the use of explosives. This legislation is required due to a recent Internal Revenue Service decision to impose this excise tax on the equipment.

Previously the explosive industry has relied on the 1970s court case in which the IRS decided not to tax explosive handling vehicles and refunded provisional taxes to the manufacturer. Based on the IRS's decision to apply retroactive tax treatment on this equipment, small businesses that manufacture this equipment that do not have the resources to pay the back taxes will possibly be forced out of business.

The explosive industry believes that the revenue impact of this legislation will be neutral. However, the Joint Committee on Taxation has estimated the revenue impact of this legislation about $150,000 per year. Based on exemptions under current regulations and the fact the IRS has not collected this tax for the last 10 years, it is questionable that there will be any revenue impact related to this legislation. If the IRS is successful in collecting this tax, the increased cost of the equipment will encourage the use of alternative means of manufacturing explosives and thus jeopardize the safety features built into explosives handling vehicles.

For the past 25 years the U.S. manufacturers of this highly specialized equipment have held a dominant position in both domestic and foreign markets. To impose this tax and apply retroactive treatment will rob these companies of the necessary working capital needed to fund further research and development and thus the loss of U.S. manufacturing jobs. This is not a new issue. This was proposed as an amendment to H.R. 11 and was passed as part of the conference report last year. As you know, H.R. 11 was vetoed by the President.

Despite the exemption this legislation seeks, explosive handling vehicles will still be subject to excise tax since the FET of $7,000 to $10,000 will continue to be paid on each chassis portion of the new vehicles. In fact, there is a potential that there may be a loss of Federal revenues if companies select to refurbish existing older units rather than purchase new ones.

Finally, this legislation makes economic sense. The current generations of explosive technology and explosives handling vehicle technology used throughout the world was developed in the United States, and the U.S. technology has continued to be the best in the world. The U.S. manufacturers of this equipment control the domestic market for this equipment and are increasing foreign market share every year. Taxing the lifeblood out of these small businesses that manufacture this specialized equipment could jeopardize our market share in foreign markets and invite foreign competition.

Last year Congress realized this legislation was good policy and included it in the tax bill. We ask that history be repeated to provide fair treatment for these industries that are so vital to the economy of our country.

Mr. HOAGLAND. Thank you, Mr. Millett.

[The prepared statement and attachments follow:]

STATEMENT OF IRECO INC./DYNO NOBEL INC.

INTRODUCTION OF LEGISLATION TO EXEMPT EXPLOSIVES HANDLING VEHICLES FROM FEDERAL EXCISE TAX

This testimony identifies the key aspects of the legislation to exempt bulk explosives handling vehicles [EHV] from the federal excise tax [FET] imposed under Internal Revenue Code 4051, also known as the "heavy truck tax."

Explosive handling vehicles are designed to safely, and economically manufacture explosives. Explosives ingredients are stored in separate compartments on these vehicles in a non-explosive state. At the blast site these vehicles, mix and load the explosives ingredients into pre-drilled bore holes. The primary consideration in the design of these vehicles is safety and manufacturing, not transportation.

The explosives industry is not seeking special treatment, but only fair treatment. The exemption sought in this legislation is the same exemption that has been granted to other industries. The heavy truck tax is to compensate the government for the additional wear and tear that these vehicles have on public roads. The explosives industry agrees with this rational, and is paying the excise tax on the chassis portion of these vehicles. This tax averages between $7,000 to $10,000 per chassis. These units are designed to safely manufacture explosives, not for transportation, and therefore will only average 60,000 to 70,000 miles during the life of the equipment. In addition, the explosives industry estimates that 70% of EHV's operate off-road, and are never on pubic roads. When comparing the amount of excise tax paid on a usage basis, the explosives industry is currently paying 30 times the amount of FET that other industries are paying.

This legislation will directly impact over 240 companies located in forty two states, as well as indirectly impact mining, construction, and quarrying industries, as well as consumers of products that are manufactured or acquired with the use of explosives. This legislation is required due to a recent Internal Revenue Service [IRS] decision to impose the excise tax on this equipment. Previously the explosives industry has relied on a 1970's court case in which the IRS decided not to tax EHV's and refunded provisional taxes to the vehicle manufacturer. Based on the IRS's decision to apply retroactive tax treatment on this equipment, small businesses that manufacture this equipment and do not have the resource to pay back taxes may possibly be forced out of business.

The explosives industry believes that the revenue impact of this legislation would be neutral. However, the Joint Committee on Taxation has estimated that the revenue impact of this legislation would be $150,000 per year. Based on exemptions under current regulations, and the fact that the IRS has not collected this tax, it is questionable that there will be any revenue impact related to this legislation. If the IRS is successful in the collection of the tax, the increased costs of this equipment will encourage the use of alternative means of manufacturing explosives, and thus jeopardize the safety features built into EHV's. For the past twenty years the U.S. manufacturers of this highly specialized equipment have held a dominant position in both the domestic, and foreign markets. To impose this tax, and apply retroactive treatment will rob these companies of the working capital needed to fund future research, and thus invite foreign competition, and the loss of U.S. manufacturing jobs.

This is not a new issue. Last year Senator Hatch of Utah offered an amendment to exempt explosives handling vehicles from FET which was passed as part of the conference report to H.R. 11. As you are aware, last years tax bill was vetoed by the President for other reasons.

The exemption sought in this legislation is the same exemption that has been granted to the cement industry. Under current regulations the bodies of cement mixers are exempt from the heavy truck tax. The manufacturing function of a cement mixer, and an EHV is strikingly similar, (appendix 1). Cement mixers blend the raw ingredients water, sand, gravel, and cement to manufacture concrete. EHV's blend the components of explosives, ammonium nitrate, fuel oil, and other trace ingredients to manufacture explosives. In some instances conventional bowl type cement mixers are used to manufacture bulk blasting agents. There are modern site mix cement trucks that like EHV's transport the raw ingredients for concrete, and then perform the manufacturing process at the job site. Granting an exemption to the cement industry, and not the explosives industry is arbitrary, and discriminating.

Based on the rational for current regulations, the explosives industry has a much stronger case for exemption than the cement industry. Unlike cement trucks that spend the majority of their time on public roads, EHV's are designed solely for the preparation of explosives mixtures used in commercial blasting applications. These operations are always off-road due to hazards to people and property caused by vibrations and fly-rock. The explosives industry estimates that 70% of all EHV's operate totally off-road. The remaining 30% spend more than half of their time off-road.

There are many different designs of EHV's dependant upon the type and complexity of the explosives mixtures that they are to manufacture. Many of the EHV's used in the United States are not suited for highway use. Due to weight and maneuverability restrictions, nigh operating costs, and limited carrying capacity, it is not practical to transport product with these vehicles on the highways. In some instances remote sites, (EHV support sites) are set-up directly at the mine, or job site, (appendix 2). The raw ingredients for the explosives are transported to the EHV support site in large tanker trailers. Like the chassis of the EHV, the explosives industry pays the excise tax on these tanker trailers. In preparation for a blasting job the EHV operator will load compartments in the EHV with the necessary raw ingredients. Only at the bore hole are these ingredients manufactured into explosives. EHV's travel an average of 5,000 to 7,000 miles per year. The majority of an EHV's time is spent in the field manufacturing explosives. When EHV's are retired from operation they have limited value and are not suited for transportation functions. Due to the structural modifications, and the amount of hours that the units have operated, they could not be refitted for transportation functions without excessive costs.

The explosives industry has and will continue to pay the excise tax on the chassis portion of the EHV. it is only the body or manufacturing portion of the vehicle that will be exempt. Based on a comparison of the heavy truck tax calculated on a usage basis, the explosives industry is paying 30 time the amount of excise tax that the trucking industry is currently paying. The reason for the disparity is the result of the limited miles that these units operate on public roads. A standard highway tractor will travel in excess of a million miles on public roads before it is retired from service. dividing the amount of heavy truck tax paid at the time the truck was purchased by the total miles traveled, equates to a tax of less than one cent per mile. In comparison an EHV will travel less than one hundred thousand miles, seventy percent of which are off-road. This same calculation for an EHV results in a tax of about thirty cents per mile, (appendix 3). The explosives industry is not asking for an exemption on the chassis portion. This analysis is only to show the amount of tax we are currently paying related to other industries. The fact that the trucking industry is paying less than one cent per mile, and the explosives industry is paying thirty cents per mile is once again arbitrary and discriminating.

The only reason that Congress must take action on this matter to enact a specific exemption for explosives handling vehicles is because the IRS in now starting to pursue the manufacturer of this specialized equipment for back and present taxes. The industry has relied on an IRS tax case from the 1970's in which the IRS decided not to tax EHV's and returned provisional taxes to the manufacturer. The IRS is now relying on a 1979 revenue ruling, 79-191, which held that the mixing units which were attached to a standard flat bed highway chassis were subject to FET.

The equipment revenue ruling 79-191 addressed was based on a style of vehicles used 15 years ago and which are no longer in use. The storage containers on those trucks could be removed, and once removed the flat bed truck could be used for other purposes. This is not the case with modern more sophisticated explosives handling vehicles which have been modified for one singular use-to mix explosives. In 1991 an IRS technical advice memorandum [TAM] cited the 1979 ruling as grounds for taxing the current generation of explosives handling vehicles. However the TAM relied on the 1970-era vehicle, rather than the modern version.

The explosives industry agrees with the 1979 revenue ruling, as it pertained to the equipment in question. In meetings with the IRS the explosives industry has shown the significant differences between the vehicles addressed in 79-191, and the current design of these vehicles. Once the body, or manufacturing portion of an EHV is removed, the chassis is not suited for any other function. The costs to convert an EHV chassis to a highway vehicle are so great it would be impractical to do so.

There is even disagreement and uncertainty in the field among IRS agents as to the taxability of this equipment. In some states IRS agents have decided the body or mixing equipment is exempt from FET, while in others, agents are going forward with collection of taxes, both past and present. This issue illustrates the uncertainty which exists regarding the taxability of EHV's.

Currently the manufacturer of this specialized equipment is appealing the determination of the IRS that this equipment is FET taxable. There is uncertainty as to the outcome of the appeal. There are several instances where the courts have ruled dual use vehicles, such as EHV's are not subject to the excise tax.

The IRS has missed the point related to the taxability of this equipment, and are taking a literal interpretation of the regulations. The position of the IRS is; if the equipment is capable of being registered for highway use, it is taxable. This position is inconsistent with the above mentioned court case where similar equipment which was fully licensed for highway use was determined to be tax exempt. Additionally, for equipment to be legally on the highways in most states it must pass safety inspections. 20% of EHV's will not pass inspection for highway use, yet they could legally be registered. In addition, the fact that 70% of these vehicles operate off-road has not been taken into consideration.

The tax impact related to this legislation is almost negligible. The explosives industry believes that this legislation will in actuality be tax neutral. Despite the exemption this legislation seeks, the EHV will still be subject to excise tax since the FET of $7,000 to $10,000 will continue to be paid on each chassis portion of new vehicles. In fact there is a potential that there may be a loss of federal revenue if companies select to refurbish existing older units rather that purchase new ones.

As discussed previously, there are companies currently using cement mixers to manufacture explosives. If additional taxes charged on EHV's that are not charged on cement mixers this trend will continue. Cement mixers are capable of manufacturing ANFO, and other bulk blasting agents however, it does not make economic sense to force companies to use inferior equipment solely for the sake of collecting taxes when there is better, and safer equipment available.

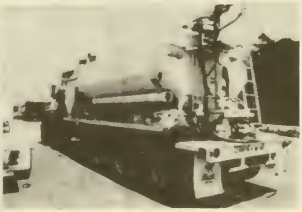
Finally, this legislation makes economic sense. The current generation of explosives technology, and EHV technology used through out the world was developed in the United States, and the U.S. technology continues to be the best in the world. The U.S. manufacturers of this equipment control the domestic market for this equipment, and are increasing foreign market share. Taxing the life blood out of these small businesses that manufacture this specialized equipment could jeopardize our market share in foreign markets, and invite foreign competition.

Last year congress realized the this legislation was good policy, and included it in the tax bill. We ask that history be repeated to provide fair treatment for these industries that are so vital to the economy of our country.

Appendix 1

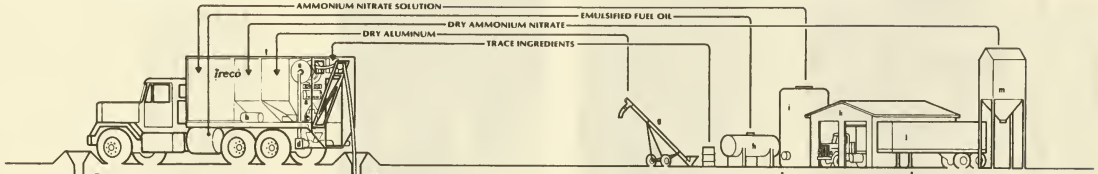
BODY USED TO PROCESS CONCRETE

BODY USED TO PROCESS EXPLOSIVES



Cement mixer bodies are exempt from excise tax. This exemption should also apply to EHV's since the equipment is similar in design and function as shown in the above photographs, and EHV's use public highways much less than cement mixers. Unfair taxation of EHV's could result in increased use of cement mixers for mixing explosives which raises serious safety concerns, does not increase tax revenues, would lead to less research and development of explosives handling technology, and result in the loss of export sales and manufacturing jobs.

EXPLOSIVES HANDLING VEHICLE (EHV)



a
CONTROL PANEL
Four different explosive formulas can be preprogrammed for rapid selection. Combination loading is possible because the panel will automatically shift from one mix to the next while filling each borehole. Pumping stops automatically at pre-set quantities and a counter tabulates the daily total.

b
EMULSION BLENDER
Emulsifiers, fuel oil and ammonium nitrate solution are metered into the IRECO proprietary high shear blender to form the emulsion.

c
MIXER
The mixer blends prilled ammonium nitrate, aluminum granules, pre-formed emulsion and density control agents into the final product.

d
SLURRY PUMP
A hydraulically powered progressive cavity pump delivers the finished product into the borehole.

e
HOSE REEL
A hydraulically powered hose reel responds to variable-speed and reversing commands. It has a capacity of 100 feet of 2 inch diameter hose.

f
CORROSION RESISTANT UNIT
Aluminum and stainless steel construction is the effects of corrosive ingredients and harsh environments.

THE ADVANTAGE OF BULK LOADING
Unlike packaged explosives, bulk products remain non-explosive until the ingredients are mixed and placed in the borehole. Once in place bulk explosives completely couple to the borehole wall to ensure optimum transfer of energy.

VARIABLE ENERGY & DENSITY
The versatile SMS system can automatically provide a preselected range of products in either single or combination loads with a wide range of strengths and densities.

WET BOREHOLES? NO PROBLEM
IRECO bulk emulsions combine medium to high density with outstanding water resistance. When pumped into a wet borehole the water is immediately displaced by a continuous column of explosives.

EHV SUPPORT SITE

g
LOADING AUGER
An alternate method of loading trucks with dry ingredients is an aluminum or stainless-steel auger. This is suitable for temporary installations and is usually charged with bagged ingredients.

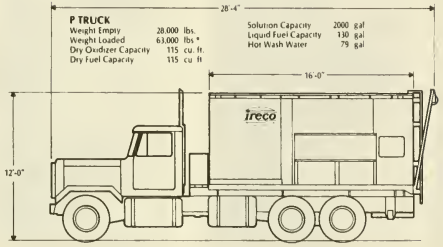
h
FUEL BLENDING TANK
The liquid-fuel component of the system is created by premixing emulsifiers and fuel oil at the plant.

i
SOLUTION TANK
The liquid oxidizer component of the system is blended, heated, and stored in an insulated tank.

j
ASU
The auxiliary support unit (ASU) is the distribution center for electricity, steam, water, high pressure water and compressed air. The units are prefabricated in 40 foot trailers which eliminates high labor costs at remote sites and enables relocation.

k
GARAGE
A prefabricated metal garage is provided for truck maintenance and repair. It is essential for operating efficiency at cold weather sites.

m
OVERHEAD SILO
Ammonium nitrate prills are gravity-fed into trucks from the overhead silo which is recharged by a pneumatic bulk delivery truck.

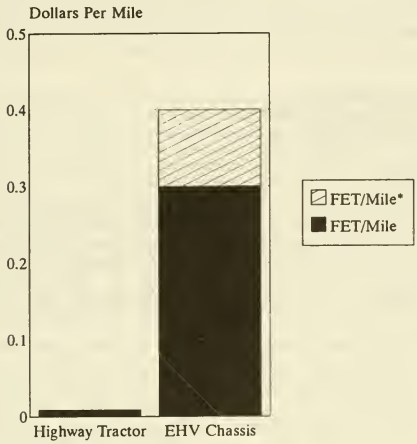


P TRUCK

Weight Empty	28,000	lbs.
Weight Loaded	63,000	lbs *
Dry Oxidizer Capacity	115	cu. ft.
Dry Fuel Capacity	115	cu. ft.
Solution Capacity	2000	gal
Liquid Fuel Capacity	130	gal
Hot Wash Water	79	gal

*a full load may exceed legal limits in your area

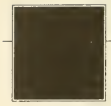
FEDERAL EXCISE TAX [FET]
(based on tax/mile)



* Based on chassis, and body

This graph illustrates the disparity in the amount of excise tax per mile that the explosives industry is paying compared to the amount of tax that the trucking industry is paying. These calculations are based on the amount of excise tax paid divided by the average highway miles the vehicle will travel. The reason for the significant difference is caused by the limited amount of miles that the explosives handling vehicles, [EHV] send on public roads. EHV's are designed primarily for safety, and manufacturing considerations, not transportation. The limited carrying capacity, and poor maneuverability of these vehicles makes them poorly suited for highway transportation.

As depicted in the graph the explosives industry is paying approximately 30 cents per highway mile on the chassis portion of these vehicles. The industry is not asking for exemption of this tax, but only asking for an exemption on the body or manufacturing portion of the vehicle.



IRECO Incorporated

Eleventh Floor Crossroads Tower
Salt Lake City, Utah USA 84144 0103
Telephone (801) 364-4800
Telefax (801) 328-6452

June 24, 1993

Mr. Charles B. Rangel
Committee on Ways and Means
1105 Longworth, H.O.B.
Washington, DC 20515-6350

Dear Mr. Rangel:

Last Tuesday, June 22nd I had the opportunity to testify before the Sub-Committee on Select Revenue Measurers regarding an exemption for explosives handling vehicles, [EHV] from Federal Excise Tax. It was not until after my testimony that I was able to review Treasury's testimony relating to this exemption. The Treasury was misstated, and I would like to clarify the explosives industry's position on the two items in the treasury's testimony.

Based on provisions under existing regulations the explosives industry believes that EHV's meet the current criteria for exemption from FET. The reason that we are asking Congress for this exemption is because the IRS is now pursuing the manufacturers of this equipment for both current and back FET. In a 1979 revenue ruling the IRS determined that a different type of equipment used to manufacture explosives was subject to FET. The equipment identified in the 1979 ruling has not been used in the U.S. for the past ten years. When considering the taxability of current EHV's the IRS only reviewed the 1979 ruling, and did not take into consideration the differences between the two vehicles.

The treasury also indicated that the "retroactive date is inappropriate because it rewards noncompliant taxpayers, and penalizes taxpayers who complied with present tax law." This is inappropriate since not one of the companies manufacturing EHV's are currently paying this excise tax. As to the fact that present law applies to EHV's is the IRS's interpretation of the regulations, obviously the explosives industry disagrees with this interpretation. This is a new attempt by the IRS to collect excise tax on this equipment.

In attempting to collect tax on the manufacturing or body portion of the EHV, the IRS must first classify the components of these vehicles as either manufacturing or transportation related. This is not possible since these functions are mutually dependant. To separate these functions would be the equivalent of trying to manufacture concrete without a mixer. In addition the IRS has not

addressed the fact that 70% of these vehicles do not travel on public roads, and of the remaining 30% that do travel on public roads, half of their time is spent off-road.

One other item the IRS has not taken into consideration, is the amount of excise tax the explosives industry is paying compared to other industries. The excise tax is based on the sales price of the vehicle, as such the excise tax paid on the chassis portion of an EHV is equivalent to the tax paid on a highway tractor. EHV's travel limited miles on public roads, (less than 30,000 miles per EHV). Comparing the excise tax on a usage basis, the explosives industry is paying 30 times the amount of tax paid by the trucking industry.

I am concerned that if the IRS is successful in their pursuit of these taxes the largest U.S. manufacturer of EHV's will be forced out of business. In order to survive in a global explosives market, it is essential to IRECO that we have the most accurate, and technologically advanced equipment possible. Forcing this EHV manufacturer out of business would be devastating to the U.S. mining, quarrying, and construction industries, not to mention the loss of U.S. jobs and technology.

I urge you to support this exemption. We are not asking for special treatment, only fair treatment.

Thank you for the opportunity you gave me to testify, I will be happy to answer any questions that you may have regarding this legislation.

Sincerely,

David G. Millett
Tax Manager, IRECO Inc./Dyno Nobel Inc

Mr. HOAGLAND. Mr. Girard.

STATEMENT OF WILLIAM C. "CHRIS" GIRARD, PRESIDENT AND CHIEF EXECUTIVE OFFICER, PLAID PANTRIES, BEAVERTON, OREG., ON BEHALF OF NATIONAL ASSOCIATION OF CONVENIENCE STORES

Mr. GIRARD. Good afternoon, Mr. Chairman and members of the committee, my name is Chris Girard, and I am president of Plaid Pantries, Inc., a 100-store convenience store chain in Portland, Oreg. I would like to shift back to the topic that the gentleman on my left was talking about, which is the special occupational tax on alcohol.

I am here today representing my company and the National Association of Convenience Stores. Before I begin, Mr. Chairman, I have a letter here that shows the number of organizations that are also supporting the repeal of this tax. I would like to enter that in the record if I could.

Mr. HOAGLAND. Yes.

Mr. GIRARD. Mr. Chairman, next week I will sign a check from a relatively small company for $26,000 payable to the U.S. Government and, frankly, I don't know why or for what. This bill is due every year at this time and it goes toward what is known as the special occupational tax or SOT. But to my knowledge my company has never been visited by any BATF officer or received any services at our stores. This money, $26,000, may not seem like a lot to the committee, but considering that convenience stores have, on average, a profit margin of only $8,200 annually, this money could be put to much better use such as reinvestment in the company or creating jobs.

I am here today to ask the subcommittee to pass a proposal being sponsored by Congressman Kopetski that would repeal this inequitable tax. As you know this tax was increased fivefold without notice as a part of the Budget Reconciliation Act of 1987. My 100 Plaid Pantry stores that sell only beer prior to 1987 paid $24 per store. Following the Reconciliation Act that year the price tag was increased to $250. Clearly, the retail segment, whether it is a convenience store or a grocery store like my friend next to me, has been hit hard by this tax. I suspect that there is an administrative function funded by this tax that certainly didn't experience anywhere near this type of growth, but that the funds were used to increase general revenues, revenues not readily visible to the general public and which provide no tangible benefits to retailers.

While I am not certain that anyone who pays this tax derives any direct benefit, it is clear to me that when I compare my bill to that, say, of a brewery, an entire brewery, the inequity becomes clear. Only four of my convenience stores pay as much as one entire brewery, an enterprise that derives 100 percent of its income from the sale of alcohol.

Mr. Chairman, I also want to use this opportunity before your subcommittee to underscore the precarious financial picture that small businesses like Plaid Pantries face, and the burden that the SOT and taxes like it place on us. These taxes come at a time when small businesses are attempting to deal with escalating health insurance costs, tremendous expenses relating to EPA compliance in

our gasoline installations, potential increase in the minimum wage, and rising business costs in general.

Why should this be important to your subcommittee? Very simply, even apparently innocuous taxes such as the SOT can adversely impact many small businesses that are already operating on the margin of survival. A few minutes ago I mentioned a figure $8,200. This modest sum is the profit that the average convenience store made for the entire year of 1992. That is all, Mr. Chairman, just $8,200. In generating this profit, and this is a key point, the store required and supported what, to me, is an incredible payroll of $120,000, including payroll taxes, Social Security and health insurance. $87,000 was direct store labor for each individual store with an additional $32,000 to support the supervisory personnel. Incidentally, this average store paid over $10,000 in various government taxes, fees and assessments. In other words, it paid $2,000 more in taxes than the profits of the store.

I am including an addendum in my written remarks showing examples of the multitude of tax and fee items required just to open the doors for business. Still, you may say, what is the problem with a seemingly small $250 tax here and there. $8,200 ought to be able to cover it. But the problem is that we and all other enterprises don't have a bunch of identical units out there generating exactly $8,200. If you look at a sample distribution of typical stores, you will see a huge variance from the most to the least profitable, typically over $100,000 profit at the top end down to a number of break even stores, even a few that are losing a little money. The point of this data is to focus on the jobs that my business and others generate and the impact that taxes like the SOT can have, especially on all those stores operating on the margin of being able to stay open and compete, or forced to close their doors.

In 1989, Mr. Chairman, when I joined Plaid Pantries, the company was teetering on the edge of financial ruin. We simply had too many stores that could not cover all operating costs. The fixed costs category, which includes the more than $10,000 annually in taxes that I mentioned, at least contributed to Plaid Pantries having to file Chapter 11 bankruptcy. When the dust cleared, we ended up with 70 fewer stores out of 170. Over a third of the company was gone, and most devastating, more than 600 people were out of work. Just think of the social costs associated with these unemployed workers; unemployment, food stamps, lost revenue to the State and Federal Government. Former payers into the social insurance system are transformed into users of the system.

It is important to note that these lost jobs are not "junk jobs." I put that in quotes. We have many employees who earn from 25 cents to several dollars above the minimum wage. We hire many part-time employees who are looking for flexible employment, students seeking to defray education costs, retirees looking to keep active and make a few dollars on the side. Many of our entry level employees move up into our company into very well paid managerial positions.

The point, Mr. Chairman, is that the SOT has an effect on jobs. With 68,000 convenience stores in the United States, probably a conservative estimate, my industry pays $17 million in this tax alone. If just 1 percent of these stores on the margin go under due

to the tax burden of the SOT and similar taxes, we destroy nearly $60 million in payroll.

In summary, Mr. Chairman, the SOT destroys jobs. It is a burden on small business, and I hope you will repeal it this session of Congress. Thank you very much.

Mr. HOAGLAND. Thank you, Mr. Girard. Your list of organizations supporting the repeal will be made part of the record without objection.

[The prepared statement and attachment follow:]

STATEMENT OF WILLIAM C. "CHRIS" GIRARD
PRESIDENT AND CEO
PLAID PANTRIES, BEAVERTON OREGON

GOOD AFTERNOON MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE. MY NAME IS CHRIS GIRARD, AND I AM PRESIDENT OF PLAID PANTRIES, INC. A 100 STORE CHAIN OF CONVENIENCE STORES BASED IN PORTLAND, OREGON. I AM HERE TODAY REPRESENTING MY COMPANY AND THE NATIONAL ASSOCIATION OF CONVENIENCE STORES.

BEFORE I BEGIN MR.CHAIRMAN, I ALSO WOULD LIKE TO GET PERMISSION TO ADD THIS LETTER FROM ALL GROUPS SUPPORTING REPEAL OF THE S.O.T. TO THE RECORD.

MR. CHAIRMAN, NEXT WEEK I WILL SIGN A CHECK FOR $26,000 PAYABLE TO THE U.S. GOVERNMENT. AND, FRANKLY I REALLY DON'T KNOW WHY OR FOR WHAT . THIS BILL IS DUE EVERY YEAR AT THIS TIME AND GOES TOWARDS WHAT IS KNOWN AS THE SPECIAL OCCUPATIONAL TAX ON ALCOHOL, OR "S.O.T." BUT, TO MY KNOWLEDGE MY COMPANY HAS NEVER RECEIVED ANY BATF SERVICES NOR HAVE WE EVER SEEN A BATF OFFICER IN ANY OF OUR STORES.

THIS MONEY -- $26,000 -- MAY NOT SEEM LIKE A LOT TO THE COMMITTEE, BUT CONSIDERING THAT CONVENIENCE STORES HAVE, ON AVERAGE, A PROFIT MARGIN OF ONLY $8,200, THIS MONEY COULD BE PUT TO MUCH BETTER USE, SUCH AS REINVESTMENT OR CREATING NEW JOBS.

I AM HERE TODAY TO ASK THIS SUBCOMMITTEE TO PASS A PROPOSAL BEING SPONSORED BY CONGRESSMAN KOPETSKI THAT WOULD REPEAL THIS INEQUITABLE TAX. AS YOU KNOW, THIS TAX WAS INCREASED FIVE-FOLD, WITHOUT NOTICE, AS PART OF THE BUDGET RECONCILIATION ACT OF 1987.

MY 100 PLAID PANTRY STORES THAT SELL ONLY BEER, PRIOR TO 1987 PAID $24 PER STORE. FOLLOWING THE RECONCILIATION ACT THAT YEAR, THE PRICE TAG WAS INCREASED TO $250 PER STORE. CLEARLY, THE RETAIL SEGMENT, WHETHER ITS A CONVENIENCE STORE, OR LIKE THE GENTLEMAN NEXT TO ME -- A GROCERY STORE -- HAVE BEEN HARD HIT BY THIS TAX.

I SUSPECT THAT IF THERE IS AN ADMINISTRATIVE FUNCTION FUNDED BY THIS TAX, IT DID NOT EXPERIENCE ANYWHERE NEAR THIS TYPE OF GROWTH, BUT THAT THE FUNDS WERE USED TO INCREASE GENERAL REVENUES ... REVENUES THAT ARE NOT READILY VISIBLE TO THE GENERAL PUBLIC AND WHICH PROVIDE NO TANGIBLE BENEFIT TO RETAILERS.

WHILE I'M NOT CERTAIN THAT ANYONE WHO PAYS THIS TAX DERIVES ANY DIRECT BENEFIT, IT IS CLEAR TO ME THAT WHEN I COMPARE MY BILL TO THAT OF SAY, A BREWERY, THE INEQUITY OF THE TAX RATE BECOMES CLEAR. ONLY FOUR OF MY CONVENIENCE STORES PAY AS MUCH AS ONE ENTIRE BREWERY -- AN ENTERPRISE THAT DERIVES 100% OF IT'S INCOME FROM THE SALE OF ALCOHOL.

MR. CHAIRMAN I ALSO WANT TO USE THIS OPPORTUNITY BEFORE YOUR SUBCOMMITTEE TO UNDERSCORE THE PRECARIOUS FINANCIAL PICTURE THAT SMALL BUSINESSES, LIKE PLAID PANTRIES FACE, AND THE BURDEN THAT THE S.O.T. AND TAXES LIKE IT PLACE ON US.

THE S.O.T. AND OTHER TAXES COME AT A TIME WHEN SMALL BUSINESSES ARE ATTEMPTING TO DEAL WITH ESCALATING HEALTH INSURANCE COSTS, TREMENDOUS EXPENSES RELATING TO EPA COMPLIANCE AT OUR GASOLINE INSTALLATIONS, A POTENTIAL INCREASE IN THE MINIMUM WAGE AND RISING BUSINESS COSTS IN GENERAL.

WHY SHOULD THIS BE IMPORTANT TO YOUR SUBCOMMITTEE? VERY SIMPLY, EVEN APPARENTLY INNOCUOUS TAXES SUCH AS THE SOT CAN ADVERSELY IMPACT MANY SMALL BUSINESSES THAT ALREADY ARE OPERATING ON THE MARGIN OF SURVIVAL.

A FEW MINUTES AGO I MENTIONED THE FIGURE OF $8,200. THIS MODEST SUM IS THE PROFIT THAT THE AVERAGE CONVENIENCE STORE MADE IN 1992. THAT'S ALL MR. CHAIRMAN -- JUST $8,200.

IN GENERATING THIS PROFIT, THE STORE REQUIRED AND SUPPORTED A RELATIVELY INCREDIBLE PAYROLL FIGURE OF $120,000, INCLUDING PAYROLL TAXES, SOCIAL SECURITY AND HEALTH INSURANCE ... $87,000 OF THIS IS DIRECT

STORE LABOR, WITH AN ADDITIONAL $32,000 IN SUPPORT AND SUPERVISORY PERSONNEL.

AND, INCIDENTALLY, THIS AVERAGE STORE PAID OVER $10,000 IN VARIOUS GOVERNMENT TAXES, FEES AND ASSESSMENTS ... $2,000 MORE THAN IT GENERATED IN TOTAL PROFITS! I HAVE INCLUDED AN ADDENDUM IN MY WRITTEN REMARKS SHOWING EXAMPLES OF THE MULTITUDE OF TAX AND FEE ITEMS REQUIRED JUST TO OPEN THE DOORS FOR BUSINESS.

STILL, YOU MAY SAY WHAT IS THE PROBLEM WITH A SEEMINGLY SMALL $250 TAX HERE AND THERE ... $8,200 OUGHT TO BE ABLE TO SUPPORT THIS. BUT THE PROBLEM IS THAT WE AND ALL OTHER ENTERPRISES DON'T HAVE A BUNCH OF IDENTICAL UNITS OUT THERE GENERATING $8,200.

IF YOU LOOK AT A SAMPLE DISTRIBUTION OF TYPICAL STORES, YOU WILL SEE A HUGE VARIANCE FROM THE MOST TO LEAST PROFITABLE. TYPICALLY, OVER A HUNDRED THOUSAND DOLLARS PROFIT AT THE TOP END, DOWN TO A NUMBER OF "BREAK-EVEN" STORES OR EVEN A FEW LOSING A LITTLE MONEY.

THE POINT OF THIS DATA IS TO FOCUS ON THE JOBS THAT MY BUSINESS AND OTHERS GENERATE AND THE IMPACT THAT TAXES LIKE THE SOT, CAN HAVE, ESPECIALLY ON ALL THOSE STORES OPERATING ON THE MARGIN OF BEING ABLE TO COMPETE OR FORCED TO CLOSE THEIR DOORS.

IN 1989, MR. CHAIRMAN, WHEN I JOINED PLAID PANTRIES, THE COMPANY WAS TEETERING ON THE EDGE OF FINANCIAL RUIN -- WE SIMPLY HAD TOO MANY STORES THAT COULD NOT COVER ALL OPERATING COSTS. THE FIXED COST CATEGORY WHICH INCLUDES THE MORE THAN $10,000 ANNUALLY IN TAXES THAT I MENTIONED EARLIER CONTRIBUTED TO PLAID PANTRIES HAVING TO FILE CHAPTER 11 BANKRUPTCY.

WHEN THE DUST CLEARED WE ENDED UP WITH 70 FEWER STORES ... OVER A THIRD OF THE COMPANY GONE ... AND MOST DEVASTATING ... MORE THAN 600 EMPLOYEES OUT OF WORK. JUST THINK OF THE SOCIAL COSTS ASSOCIATED WITH THESE UNEMPLOYED WORKERS .... UNEMPLOYMENT COMPENSATION, FOOD STAMPS, AND LOST REVENUE FOR THE STATE AND FEDERAL GOVERNMENT. FORMER PAYERS INTO THE SOCIAL INSURANCE SYSTEM ARE TRANSFORMED INTO USERS OF THE SYSTEM.

AND, IT'S IMPORTANT TO NOTE THAT THESE LOST JOBS ARE NOT "JUNK" JOBS. WE HAVE MANY EMPLOYEES WHO EARN 25 CENTS TO SEVERAL DOLLARS ABOVE THE MINIMUM WAGE. WE HIRE MANY PART-TIME EMPLOYEES WHO ARE LOOKING FOR FLEXIBLE EMPLOYMENT, STUDENTS SEEKING TO DEFRAY EDUCATION COSTS, AND RETIREES LOOKING TO KEEP ACTIVE AND MAKE A FEW DOLLARS. MANY OF OUR ENTRY LEVEL EMPLOYEES MOVE UP IN OUR COMPANY TO VERY WELL PAID MANAGERIAL POSITIONS.

THE POINT, MR. CHAIRMAN, IS THAT THE SOT HAS AN EFFECT ON JOBS. WITH 68,000 CONVENIENCE STORES IN THE U.S. -- A CONSERVATIVE ESTIMATE -- MY INDUSTRY PAYS $17 MILLION IN THIS TAX ALONE. IF JUST ONE PERCENT OF THESE STORES GO UNDER DUE TO THE HEAVY TAX BURDEN OF THE S.O.T., AND NO SIMILAR TAXES, WE DESTROY NEARLY $60 MILLION DOLLARS IN PAYROLL.

IN SUMMARY MR. CHAIRMAN THE S.O.T. DESTROYS JOBS. ITS A BURDEN ON SMALL BUSINESSES AND I HOPE THAT YOU WILL REPEAL IT THIS SESSION OF CONGRESS.

TAX AND FEE ITEMS REQUIRED TO OPEN A BUSINESS

ALL LOCATIONS

- Federal Special Stamp Tax
- State Personal Property Tax
- State Real Property Tax
- City Business License

WASHINGTON LOCATIONS

- City Grocery License
- City or County Tobacco License
- County Department of Health Food Service Establishment Permit (Processed Meat Sellers License)
- County Fire Marshall Fees for Operation of Equipment in Conjunction with Storage, Handling, Use or Sale of Flammable/Combustible Liquids
- Air Pollution Control Authority Registration Fee
- Department of Ecology Underground Storage Tank Registration Fee
- State Master License which includes endorsement for:
  Cigarette Retailer
  Beer Off - Premises
  Wine Off - Premises
  Shopkeeper
  Lottery Retailer
- Business & Occupational Tax
- Litter Tax

OREGON LOCATIONS

- City Business Tax
- City Fire Bureau Hazardous Substance Fee
- State Department of Environmental Quality Retailer Marketing Fee to Sell Alcohol Gas
- Department of Environmental Quality Underground Storage Tank Permits
- State Board of Pharmacy License
- State Department of Agriculture Food Establishment License
- Department of Agriculture Measuring Device Fee for Remote Readouts
- State Liquor License
- City Endorsement Fee for State Liquor License
- County Endorsement Fee for State Liquor License

Organizations Supporting Repeal Of The Special Occupational Tax On Alcohol

June 22, 1993

The organizations listed below support efforts to repeal the Special Occupational Tax on Alcohol (SOT) on all businesses that sell, manufacture, serve, or distribute alcohol beverages.

The SOT is an antiquated form of taxation that is imposed annually by the federal government. Although the SOT dates back to the civil war, it was not a major issue until the 1987 Budget Reconciliation Bill dramatically increased the fees for retailers, wholesalers and manufacturers by as much as 1000 percent in some cases.

The increase has fallen particularly hard on many small businesses. Whether it is a "mom and pop" food store, a family-owned and operated winery, a bed and breakfast inn that offers a complimentary glass of wine, or a campground or other seasonal facility opened only during certain months, these businesses, which create numerous employment opportunities, are unreasonably burdened by this annual tax.

With the 1991 hike in federal excise taxes on beer, wine and spirits, as well as increases in state taxes, the continued application of the SOT further diminishes the profitability that businesses depend on for survival. In fact, the businesses subject to the SOT already contribute, in a significant way, to both state and federal revenues through other established tax requirements.

The General Accounting Office has, on numerous occasions, analyzed this issue and concluded that the SOT is inequitable, costly to administer, and should be repealed. Last year, the House Ways and Means Committee supported a similar repeal proposal sponsored by Representative Robert Matsui (D-CA).

Sincerely,

American Hotel and Motel Association
American Vintners Association
Bed and Breakfast Association of Virginia
Benevolent and Protective Order of Elks
Beer Institute
Distilled Spirits Council of the United States
Florists' Transworld Delivery Association
Food Marketing Institute
Moose International
National Association of Beverage Retailers
National Association of Chain Drug Stores
National Association of Convenience Stores
National Association of Retail Druggists
National Beer Wholesalers Association
National Campground Owners Association
National Licensed Beverage Association
National Restaurant Association
National Wine Coalition
The National Club Association
National Council of Chain Restaurants
National Grocers Association
Knights of Pythias
Petroleum Marketers Association of America
Professional Association of Innkeepers International
Society of American Florists
The Wine Institute
Wine and Spirits Wholesalers of America, Inc.

Mr. HOAGLAND. Mr. Neal.

Mr. NEAL. Thank you, Mr. Chairman. A couple questions for Mr. Lovain. A number of Massachusetts exporters and officials of the port authority have indicated to us that the harbor maintenance tax in its current form hinders their competitiveness in world markets. Could you lay that out for the members of the subcommittee.

Mr. LOVAIN. Certainly. It is a substantial part of the transportation cost for many exporters, for example. There is one company I know of that deals with precious metals. The harbor maintenance tax is half of its transportation costs, the harbor maintenance tax alone. When you deal with bulk commodities, pennies can make a difference in whether you have a sale or not. A tax of this size on exports in the competitive international marketplace can make a great deal of difference to exporters.

Mr. NEAL. Could you explain how the tax affects U.S. manufacturers who compete in the world markets and those who must import raw materials.

Mr. LOVAIN. They have the added cost on the raw materials imported. The harbor maintenance tax increases that cost to them, and then when they export again there is the additional cost of the harbor maintenance tax on the export of the processed product. All of these things make it harder to compete against foreign competitors that don't face that kind of charge.

Mr. NEAL. I just want to point out for the record, too, that my district is 100 miles removed from a harbor in Boston, but I do think it is terribly important to the entire economy of the State of Massachusetts and indeed to New England. Logan Airport, for example, is critical to the success of the entire New England economy. I think we ought to make sure that is on the record. Thank you, Mr. Lovain.

Mr. HOAGLAND. Mr. Kopetski.

Mr. KOPETSKI. Mr. Chairman, Chris Girard is President and CEO for Plaid Pantries which is an Oregon-based company, located in Beaverton, Oregon, which is not in my congressional district either, but he has brought an old issue to the members of this committee. Last year the committee unanimously adopted a measure to repeal the SOTs which was taken up under the suspension calendar. I want to reemphasize a point from Mr. Girard's testimony about the burden of this tax on small businesses.

As you were saying, a business has to pay $250 per location no matter what income it receives from the sale or distribution of alcohol. According to Oregon's bed and breakfast guild, even if they give a guest, say, a complimentary glass of Oregon wine, for example, they are subjected to the tax; is that not correct?

Mr. GIRARD. That is correct. That is my understanding.

Mr. KOPETSKI. So I have heard from a number of constituents and small businesses, I think people tend to think of this just as, in terms of large grocery stores or even convenience stores, but it is anybody is impacted by this at $250 a pop, and yet there is no benefit received from this tax in terms of government service. It is pure revenue raising; is that your understanding?

Mr. GIRARD. That is correct. I literally don't know what the funds are used for. It is just not part of our routine. We never see, we never deal with BATF.

Mr. KOPETSKI. Right. And I don't think BATF ever stops by any of the Oregon bed and breakfasts, of which there are many in our State as well, an important part of the tourist industry.

Mr. GIRARD. No, I don't think so.

Mr. KOPETSKI. I hope the subcommittee can look favorably upon this provision as well. Thank you, Mr. Chairman.

Mr. HOAGLAND. Mr. Payne.

Mr. PAYNE. I want to welcome our colleague, Bob Goodlatte, here who represents the district next to mine. He has been a leader on a number of issues, including the one that Mr. Millett has testified about here today. Certainly we appreciate Mr. Millett, your testimony, and appreciate the work that Bob has done on this issue. We appreciate your being here and helping us better understand this matter. The testimony you have given to us will be very useful as we build this legislative record. Thank you.

Mr. HOAGLAND. Let me comment that I think we have had excellent testimony today presented by a number of individuals that certainly have good cases to make with respect to the tax relief. The burden on grocery stores is quite considerable, and I think I know all of us have heard from grocery stores from our districts.

I wanted to ask you, Mr. Harper, about this proposal to shift 1 cent of the tax on diesel fuel used by railroads into an intercity rail passenger capital improvement trust fund. Where do those funds currently go, Mr. Harper?

Mr. HARPER. Those funds are currently used to reduce the deficit, and go into the general fund.

Mr. HOAGLAND. So they go to the general fund and are dedicated for deficit reduction?

Mr. HARPER. Yes, sir.

Mr. HOAGLAND. So if we shift them into any other fund they are more likely to be spent, less likely to be applied for deficit reduction?

Mr. HARPER. That would be correct.

Mr. HOAGLAND. Mr. Capon, if this proposal is adopted, your intent would be to spend these funds, right?

Mr. CAPON. Yes. I should say that I believe the Joint Committee on Taxation has determined that this proposal is revenue neutral, the rationale being that the money that is spent out of this fund would be that much less spent by Amtrak out of general funds.

Mr. HOAGLAND. But your intent and that of supporters of this proposal would be to spend the money for capital improvement for intercity rail?

Mr. CAPON. That is correct, yes.

Mr. HOAGLAND. Now, I wonder, is there a relationship, Mr. Capon, between freight railroad, the kind of freight railroad services offered by Union Pacific in my district and other railroads and intercity rail passenger service?

Mr. CAPON. Some of the investments related to infrastructure would have freight benefits, and my written statement includes a suggestion near the end of page 3—anticipating the railroad industry's concern—that one possible compromise would be to restrict the investment to those projects that also have freight benefits.

Mr. HOAGLAND. I am just wondering about the connection. I wonder if we might take Mr. Lovain's harbor maintenance fee maybe

and apply it, if there is any closer connection between using the harbor maintenance fee and using a tax on freight railroad for the purposes that you would like to spend it for.

Mr. CAPON. Well, I think the connection is closer between those rail passenger infrastructure improvements that would have freight benefits as well than it is to harbor maintenance. Obviously, our first choice was the Swift proposal of last year.

Mr. HOAGLAND. Mr. Harper, would there be any benefits to the freight system if these funds were spent on intercity passenger rail?

Mr. HARPER. Basically the answer is, no, there would not be benefits to the freight railroads. As you may recall from my testimony, I mentioned that the freight railroads got out of the rail passenger business. At one time the freight railroads were a distinct class of citizens who supported passenger rail service in the United States at a cost of approximately $850 million a year in 1993 dollars. That is an honor we would like to pass on if that is the offer that we have today to create a new trust fund that basically would discriminate against the freight railroads and their shippers and ask them to be the ones to make up the funding for the rail passenger service. We feel strongly that such a proposal is inappropriate.

As a matter of fact, we have nothing against rail passenger service and think there are tremendous benefits to be recognized from rail passenger service, but it is not our business, and we don't see that we should be discriminated against as a small group of citizens to pay for a service which benefits our society broadly, and in particular rail passengers and highway users, who would benefit from less congestion on our highways.

Mr. HOAGLAND. Wouldn't it be fairer, Mr. Capon, to ask railroad passengers to pay a user fee to fund these improvements rather than reaching out into some other industry and assessing them?

Mr. CAPON. No, I don't think that is practical because Amtrak today sets their fares at a level that maximizes their revenue, so if you were to increase the fare for the purpose of collecting this tax, if Amtrak marketing has been doing their job correctly, you actually reduce the revenue intake. The problem we have is that when we fund transportation from mode-specific funds, what that means basically is what you see is what you are going to get more of, and so the highways and aviation remain the dominant modes. They have the ability to come in under the rules of the game and just build more highways and airports, and the problem is that means decisionmakers at the State and local levels are constantly making decisions in favor of those modes not because they are the best way to solve a particular problem, but because the well-established trust funding mechanisms are in place and make it easy for them to spend money on those types of projects, and what we are trying to find is a way to break out of that cycle that keeps the rail passenger business very small. During the decades when the transportation system was developing, you had major government investment going into highways and airports while not going into rail passenger service.

As Mr. Harper said, the rail passenger service was subsidized by the freight railroads, and you had situations where, for example, the railroads were paying taxes on their passenger terminals while

the government was spending public funds on building airports, including some of the money that the railroads were paying on their facilities.

Mr. HOAGLAND. So you are really suggesting that rail passengers should break into the highway trust fund, aren't you, if you want an intermodal system? I mean, isn't that——

Mr. CAPON. Well, I think my statement was that our first choice was Congressman Swift's bill, H.R. 4414, which would have earmarked 1 penny of the entire 2½ cents going to deficit reduction, including the railroad portion, but not in what Mr. Harper would call a discriminatory way. I should say that those railroad payments are also made by Amtrak and the commuter railroads, albeit a very small percentage of the total deficit reduction rate.

Mr. HOAGLAND. Mr. Harper.

Mr. HARPER. Many of the countries overseas have excellent passenger services, but let me say first I think that Amtrak is a very well run operation, perhaps collecting more out of the fare box to cover their operating expenses than any other rail passenger system in the world. What other countries do is to pay the operating deficits in large measure out of general revenues. They recognize that rail passenger service is an important element of their national transportation system, and therefore regard it as a general obligation, as any other expenditure of government would be.

Mr. HOAGLAND. But in any event, Mr. Harper, this could easily mean less deficit reduction than we have under present law if these funds were to be transferred, don't you think?

Mr. HARPER. Yes, the formation of such a trust fund could well do that.

Mr. HOAGLAND. Do any other—are there any other questions from members of the panel?

Mr. CAPON. Mr. Chairman, could I make one quick point with regard to Europe. What is also distinctive about the United States is the use of highway taxes primarily for transportation. In Europe only about one-quarter to one-third, depending on the country, is retained for highways.

Mr. HOAGLAND. OK. Thank you, Mr. Capon. Thank you, members of the panel.

Mr. Harper, do you have a final comment you wanted to make?

Mr. HARPER. I just wanted to express my appreciation for the understanding that you and some of the other members of your panel have for this issue of trust funds and the railroads.

Mr. HOAGLAND. Well, it is very difficult, no question. About everything is underfunded in this country these days, but overall we have to reduce the deficit, and that is the proposal the President has brought to us. That has to be our number one goal. Anyway, appreciate all of you coming and testifying. We are under a vote now. I think the procedure we will follow, Mr. Kopetski is going to take over the chairmanship. He has gone to vote and he will be back shortly. In the meantime if the next panel could come up and take your places. Thank you for those of you who just completed your testimony.

If the final panel could come up and take their places, we will get started on that.

What we have decided to do is just to recess the hearing for 10 to 15 minutes so we can go vote. Mr. Kopetski will be back shortly from voting and as soon as he gets back, probably in 5 minutes, he can resume the hearing. Is that all right? So the committee will stand in recess until Mr. Kopetski returns and reconvenes the hearing.

[Recess.]

Mr. KOPETSKI [presiding]. The subcommittee will return to order. We have our fifth panel for the day. We have three individuals. Representing the Navajo Nation, we have Faith Roessel, the executive director; representing the National Congress of American Indians. We have Rachel A. Joseph, the interim executive director; and finally, representing the Savings and Community Bankers of America, we have Edward P. Lorenson, vice chairman, chairman, president and CEO of Bristol Savings Bank, Bristol, Conn. First we will hear from the Navajo Nation, Faith Roessel.

STATEMENT OF FAITH ROESSEL, EXECUTIVE DIRECTOR, NAVAJO NATION

Ms. ROESSEL. Hello, Mr. Chairman, thank you for the opportunity to be here today to testify before this committee. President Zah of our Nation sends his apologies for not being here. As I am sure you have heard we have a mystery illness that is striking members of our Nation as well as others in the Southwest, and he is tending to that crisis right now. Certainly what that has pointed out is the huge health deficit that we have and what I am here to talk about today is the enormous infrastructure deficit that exists on Indian reservations in terms of employment opportunities and trying to attract businesses to Indian country.

This morning the committee did hear remarks from Chairman Richardson of the Subcommittee on Native American Affairs of the Natural Resources Committee, and it is his bill that we are testifying in support of, H.R. 1325. Chairman Richardson has exerted leadership in this area, which we appreciate very much, and he is our own representative from New Mexico. I would also like to acknowledge support of the National Congress of American Indians, the largest and oldest Indian intertribal organization of 119 tribes. This just points to the fact that this proposal, H.R. 1325, has widespread support and is something that is of monumental importance. This is why it is interesting to note that H.R. 1325 was categorized as a miscellaneous issue, but to us it is by no means that. It is enormously important to us.

What I have found in my experience in working on the Hill is that Indian issues many times get categorized under miscellaneous. If you look at any bill we end up somehow in that category because no one knows what to do with us, about our unique status, our unique needs. We are here today to say that we have come up with this proposal. It is derived from Indian country in terms of two very important incentives. That is, the employment incentive and the investment tax incentive.

What I would like to urge upon the committee is that this proposal be treated as a separate proposal from what is now under consideration under the empowerment zones. Although the administration has provided comments today to the committee that the

creation of tax incentives for economically distressed areas, including Indian reservations, is addressed in their proposal, and as such is dealt with, I would have to disagree on behalf of our nation and other Indian tribal governments. The presumption is there is an even playing field out there, meaning that the tax incentives are not an entitlement and as such we believe that you need to create some extra incentive, a differential to attract businesses on to Indian reservations. We do not have so many of the basic necessities that businesses look to relocate to an area. So, under the current administration's proposal, we would disagree and say that there still needs to be this other incentive in legislation that would be targeted to Indian country and that would have an increased tax incentive program to attract businesses.

This tax legislation has a proven track record from last year. It was included in H.R. 11. It has survived Floor votes on the Senate side and has widespread bipartisan support. Thank you very much.

[The prepared statement follows:]

NAVAJO NATION WASHINGTON OFFICE

PETERSON ZAH
PRESIDENT

MARSHALL PLUMMER
VICE PRESIDENT

FAITH R. ROESSEL, ESQ
EXECUTIVE DIRECTOR

1101 17TH STREET, N.W., SUITE 250
WASHINGTON, D.C. 20036
TELEPHONE (202) 775-0280
FACSIMILE (202) 775-0075

Subcommittee on Select Revenue Measures
Committee on Ways and Means
U.S. House of Representatives

Hearings on Miscellaneous Revenue Issues

TESTIMONY OF FAITH R. ROESSEL
EXECUTIVE DIRECTOR
NAVAJO NATION WASHINGTON OFFICE
ON

INDIAN EMPLOYMENT AND INVESTMENT TAX INCENTIVES TO ADDRESS INDIAN COUNTRY UNEMPLOYMENT AND INFRASTRUCTURE DEFICIENCIES

My name is Faith Roessel. I serve as Executive Director of the Navajo Nation Washington Office, and appear today on behalf of President Peterson Zah and the Navajo Nation. With a total land area that is the size of the state of West Virginia, we are the country's largest and most populous Indian tribe. The Navajo Nation spans three states -- Arizona, New Mexico and Utah -- and encompasses almost one-third of all American Indian lands in the Lower-48 states.

Mr. Chairman and Members of the Subcommittee, the Navajo Nation greatly appreciates this opportunity to testify in strong support of the "Indian Employment and Investment" tax incentives, re-introduced as H.R. 1325 by Chairman Bill Richardson of the Natural Resources Committee's Subcommittee on Native American Affairs. As President Zah testified on March 16 before the full Committee, H.R. 1325 contains the identical provisions which the Senate adopted, the House Conferees accepted, and the 102d Congress enacted last October as Sections 1131 and 1132 of H.R. 11, the "Revenue Act of 1992" which President Bush vetoed.

INTRODUCTION

President Zah regrets that he could not be here today as well. As you may know, a substantial portion of his time, attention and energy has been directed toward leading our people through the fears and uncertainty associated with the tragic "mystery illness" that has afflicted the Navajo Nation and surrounding areas. The Navajo people gratefully thank all those who have extended their help and prayers, including many Members of the House and Senate -- and especially our caring and attentive delegations from Arizona, New Mexico and Utah.

It is ironic, though, that it often takes a highly-publicized tragedy before people will line up to extend a helping hand. In contrast, when we try to focus attention on the daily tragedy of life on Indian reservations, and to persuade the Congress' tax-writing Committees of the urgent need for these "Indian Employment and Investment" tax incentives, American Indians typically find themselves last in line.

These Indian country tax credits were categorized as a "miscellaneous issue" in the Subcommittee's notice of these hearings, and were just one of 140 different issues listed in the Subcommittee's press release. Mr. Chairman, I want to assure the Subcommittee that this "miscellaneous" issue is of monumental importance for hundreds of thousands of American Indians who struggle to live with dignity on reservations located across 32 states.

With regard to the other 139 issues, I respectfully ask the Subcommittee to consider carefully the following question: Is there a single instance among those 139 other issues where the proponents of that issue share the following circumstances that American Indians face day-in and day-out in their daily lives?

-- AVERAGE INDIAN RESERVATION UNEMPLOYMENT RATE OF 56% NATIONWIDE

-- Perpetual and pervasive poverty (coincidentally 56% live below the poverty line in the Navajo Nation, which is considered one of America's "better off" Indian tribes)

-- Massive infrastructure deficiencies (for example, there are only 2,000 miles of paved roads on the Navajo Nation, while West Virginia -- which is the same size -- has over 18,000 miles)

-- Substandard housing, with the majority of American Indian reservation homes lacking running water, or electricity, or telephone service, or all of the above

-- Inadequate drinking water systems, solid waste disposal landfills, etc.

-- Overall living conditions which -- right here within the borders of the United States of America -- are far worse on most reservations than currently exist in many of the Third World countries to which the federal government provides substantial foreign aid.

This list is endless and these conditions are shared, reservation-by-reservation, by American Indians living in:

Alabama	Maine	North Dakota
Alaska	Massachusetts	Oklahoma
Arizona	Michigan	Oregon
California	Minnesota	Rhode Island
Colorado	Mississippi	South Dakota
Connecticut	Montana	Texas
Florida	Nebraska	Utah
Idaho	Nevada	Washington
Iowa	New Mexico	Wisconsin
Kansas	New York	Wyoming
Louisiana	North Carolina	

As President Zah has testified:

> Stated simply, there is no single group of U.S. citizens that -- uniformly -- is more economically-deprived than American Indians living on reservations; there is no classifiable set of locations that -- uniformly -- is more deficient in infrastructure and job opportunities than Indian reservations.

And, as President Zah has explained in support of these "Indian Employment and Investment" tax incentives:

> Helping American Indians to help themselves is neither a Democratic issue nor a Republican issue; it's not a conservative policy or a liberal policy; it's not even a "special interest" issue. **Rather, it is a "human" issue that must, and deserves to be, addressed from a national perspective on a bipartisan basis, and with a real sense of urgency warranted by the deplorable conditions existing in Indian country -- conditions which truly are a national disgrace.**

WHY INDIAN COUNTRY CAN, AND SHOULD, BE COVERED BY A SEPARATE RESERVATION-BASED PROGRAM

At the outset, it is critical to explain once again the reasons why it is essential that Indian country be singled out -- as it was in H.R. 11 -- for a separate program of tax incentives that differs from (and exceeds) incentives made available to promote new investment and jobs in non-Indian areas of the nation. The absolutely unique problems endemic to investing in Indian country necessitate a program that distinguishes Indian country and that provides potential investors/employers a higher level of incentive (i.e., the so-called "Indian differential") to help overcome those unique obstacles to economic development:

(a) As noted above, **THE AVERAGE INDIAN RESERVATION UNEMPLOYMENT RATE IS 56% NATIONWIDE.** This "incomprehensible" statistic is underscored by the fact that the full investment tax credit is targeted to reservations where Indian unemployment levels exceed the national average by at least 300% -- and that most tribes would qualify.

(b) Infrastructure deficiencies in Indian country are likewise "incomprehensible." Roads, telephones, electricity, running water, hospitals, etc., are taken for granted by investors/employers even in the most distressed inner cities of the United States, but their absence from large portions of Indian country poses a daunting barrier to tribal leaders' attempts to attract those same potential investors/employers.

(c) These massive infrastructure deficiencies, "double taxation" by the states and related problems lead to the same result nationwide -- Indian reservations in 32 states do not compete on a level playing field with even the most economically-distressed non-Indian areas.

(d) Under these circumstances, it is unreasonable to expect that Indian country can benefit from tax incentives (including "empowerment zones" and "enterprise communities") that are identical to incentives offered (or targeted) to non-Indian distressed areas as well. In other words, given the choice, potential investors/employers would in almost all instances opt to locate in non-Indian areas to avoid the unique difficulties -- particularly the higher non-wage costs caused by the lack of infrastructure -- that are inherent in locating on reservations. Rather than helping level the playing field, provision of identical incentives to Indian and non-Indian areas would simply preserve the pre-existing unlevel playing field, while changing only the overall level at which the competition for economic development occurs.

(e) It is for these reasons that Indian country requires a separate, reservation-based program (i.e., a response that fits the problem). Fortunately, the trust responsibilities, treaty obligations and laws of the United States provide the basis for Congress to do so. Adopting a separate, reservation-based program for American Indians is consistent with the distinctive legal and political status of Indian tribes and their government-to-government relationship with the Federal government, and has been upheld by the Supreme Court. (Morton v. Mancari, 417 U.S. 535 (1974)).

INDIAN EMPLOYMENT AND INVESTMENT TAX INCENTIVES

Indian Country Tax Incentives: The Preferred Approach -- The "Indian Employment and Investment" tax incentives contained in H.R. 1325 are identical to those added last year to H.R. 11 by the Senate, accepted by the House Conferees, and thereafter adopted by the full Congress in October, 1992. The legislative language is set forth at pages 45 - 53 of the "Conference Report to Accompany H.R. 11" (H.R. Report No. 102-1034, issued October 5, 1992); the Conference Committee's detailed explanation of those Indian country tax incentives can be found at pages 715 -718 and 721 - 725 of the Report.

In summary, the **Employment Credit** provides for a 10% credit to the employer based on the qualified wages and qualified health insurance costs paid to an Indian. As an added incentive, a significantly higher employment credit of 30% is offered to reservation em-

ployers having an Indian workforce of at least 85%. The credit, which is limited to "new hires" and to those employees who do not receive wages in excess of $30,000, focuses on job creation and would be allowed only for the first seven years of an Indian's employment.

The Investment Tax Credit is geared specifically to reservations where Indian unemployment levels exceed the national average by at least 300%. The legislation provides 10% for personal property, 15% for new construction property and 15% for infrastructure investment on or near reservations. (If a nationwide investment tax credit and/or employment credit were to be adopted in 1993, the Indian reservation tax credit percentages would likely need to be adjusted upward to maintain the so-called "Indian differential," which is absolutely essential in order to help mitigate the unique problems -- particularly the lack of infrastructure -- that act as disincentives to Indian country investment.) One-half of the specified credit percentages would be available for qualifying investments on reservations where unemployment exceeds 150% but does not exceed 300% of the national average.

In response to concerns raised by several Members during Senate consideration of these measures in 1992, "anti-gaming" restrictions were incorporated in H.R. 11. These prevent both the investment and employment incentives from being used with respect to the development and/or operation of gaming establishments on Indian reservations.

Most importantly, these incentives would potentially benefit all of Indian country. This is the critical difference between these Indian country tax incentives and the alternative approach proposed earlier this year by the Administration, and accepted by the House, in providing for just one Indian empowerment zone and five enterprise communities.

Empowerment/Enterprise Zones and Other Pending Proposals Will Not Help Indian Country -- The empowerment/enterprise zone provision is woefully inadequate for Indian country. Again, it is a legislative response that just does not fit the problem.

The limited Indian empowerment/enterprise zone proposal could possibly help six tribes, but would actually prove counterproductive because it would dash the hopes of the many other reservations around the country which were not selected as zones, and whose people would not benefit at all. Thus, for all of those reservations not selected, an Indian empowerment/enterprise zone approach would leave unabated the pervasive poverty and high unemployment that have perpetually defined life on those reservations.

Significantly, Mr. Chairman, even those six reservations that might be selected as zones would be unlikely to benefit. First, some of the zone-specific incentives contained in the Administration's proposal would have little usefulness in Indian country (e.g., the low-income housing credit). More importantly, as explained above, due to the lack of infrastructure, "double taxation" by the states and related problems, **Indian reservations simply cannot compete with even the most economically-distressed inner cities and other non-Indian communities.** In other words, given the choice, new business would in almost all instances opt to locate in non-Indian areas to avoid the unique difficulties that are inherent in locating on reservations. Therefore, Indian empowerment/enterprise zones offering the identical incentives as non-Indian rural zones would remain unable to compete on anything close to a level playing field.

Similarly, it is unreasonable to expect that Indian country can benefit from proposals for nationwide tax incentives (e.g., an extended/expanded targeted jobs tax credit) where the tax incentives offered to Indian country are identical to incentives available in non-Indian areas as well. Thus, by not recognizing and taking steps to address (i.e., by providing incentives that contain, or constitute, an "Indian differential") Indian country's unique problems, proposals for nationwide incentives offering identical benefits in Indian and non-Indian areas would simply preserve the existing unlevel playing field.

INDIAN COUNTRY TAX INCENTIVES ARE URGENTLY NEEDED

For almost a decade, Chairman Daniel Inouye, Co-Chairman John McCain, Senator Pete Domenici and other Members of the Senate's Committee on Indian Affairs had sought tax code amendments to create incentives for new private sector investment in Indian country. However, little progress was made during that period. As Chairman Inouye noted in his comments praising Congressional adoption of these tax incentives in H.R. 11, "it has been a difficult, and I must admit, an often lonely battle to compete with numerous other interests seeking changes to the tax code before the Finance Committee" and, I might add, the House Ways and Means Committee.

In 1992, President Zah designated federal tax incentives as one of his administration's highest legislative priorities. Drawing from bills previously introduced by Chairman Inouye, Co-Chairman McCain, Senator Domenici and other Indian Committee Members, the Navajo Nation developed the initial legislative language for these particular employment and investment tax incentive proposals. Thereafter, under the bipartisan leadership of Chairman Inouye, Co-Chairman McCain, Senator Domenici and Senator Simon of the Indian Affairs Committee, with the interest and attention of Senators Baucus and Boren of the Finance Committee, and ultimately with the support of then-Chairman Bentsen and Ranking Member Packwood of the Finance Committee, the full Senate adopted the Indian country tax incentives in lieu of the then-pending Finance Committee bill provisions that would have created enterprise zones on just ten reservations. Subsequently, the Senate-passed provisions were accepted by the House in Conference, and enacted in the vetoed H.R. 11.

Indian Country Tax Incentives Are Consistent With Clinton Administration Goals -- Having come so far in 1992, Indian country felt reasonably confident that the new Administration would take the lead in promoting these measures to help address the staggering Indian unemployment levels and the massive reservation infrastructure deficiencies that exist -- uniformly -- in Indian country. When President Zah participated in President Clinton's pre-Inauguration "Economic Summit" in Little Rock, he reviewed the urgent need for Indian economic development; explained that new investment and jobs in Indian country would also spill over to provide economic benefits to adjoining non-Indian communities; and stressed that American Indians are not looking for hand-outs, but only a helping hand.

Frankly, the Administration's failure to include these Indian country tax incentives in its proposals has been a major disappointment. Regrettably, the inaction to date by the Administration and the Congress means that, with regard to the adoption of meaningful, tax-related measures that can potentially help all reservations, Indian country may once again be left behind, or left out altogether.

In "putting people first," the federal government could well benefit from giving priority attention in 1993 to those citizens whom our nation historically has neglected until last -- American Indians. These Indian country tax incentives offer hope throughout all of Indian country that new private sector investment, jobs, and infrastructure development may at last become a reality in some of the most destitute areas of the United States. As a result, the Indian reservation investment and employment tax incentives enjoy the support of Indian tribes across the nation.

Mr. Chairman, these employment and investment incentives respond to a demonstrated need requiring urgent action. They offer an easy-to-understand, simple-to-administer, private sector-oriented approach to Indian country economic development without creating a new layer of governmental bureaucracy (e.g., such as the newly-proposed "Enterprise Board"). They only cost the federal government if they work; even then, estimated costs are comparatively modest ($209 million over a five-year period according to the new Joint Committee on Taxation revenue estimate issued May 3, 1993).

Significantly, the Indian country tax incentives have a proven legislative track record and continuing bipartisan support in the Congress.

CONCLUSION

American Indians cannot continue -- for yet another generation -- to compel our young people to leave their homes and their families because meaningful employment opportunities are lacking in Indian country. Today, these "Indian Employment and Investment" tax incentives remain as urgently needed as ever before.

Mr. Chairman and Members of the Subcommittee, this is at least the sixth time in the past sixteen months that the Navajo Nation has testified (and/or submitted a formal written statement) in support of these Indian country tax credits at scheduled Congressional hearings. Three of these occasions have been before Ways and Means. I hope that, somehow, I have convinced this Subcommittee that, with respect to the daily tragedy of Indian reservation life, we would welcome your lining up to extend a helping hand.

I respectfully request that you exercise the necessary leadership to adopt these same "Indian Employment and Investment" tax incentives that Congress already passed last October. Please finish the job in 1993, so that the Navajo Nation and tribal leaders in 32 states can begin using these tools to attract new jobs and investment, and thereby improve the lives of their people.

June 22, 1993

* * *

Mr. KOPETSKI. Thank you very much for your testimony, and I appreciate your staying within the 5 minute rule. You are a true veteran of Congress.

Ms. Joseph, our colleague, Congressman Brewster, is detained at another meeting, and sent a message saying that he regrets the fact that he is not here to give you the glowing introduction that you have earned, and so we will leave a spot in the record for that glowing introduction and look forward to your testimony now.

STATEMENT OF RACHEL A. JOSEPH, INTERIM EXECUTIVE DIRECTOR, NATIONAL CONGRESS OF AMERICAN INDIANS

Ms. JOSEPH. Thank you, Mr. Chairman, and thank your subcommittee for the opportunity to testify today.

My name is Rachel Joseph. I am the interim executive director of the National Congress of American Indians, which is the oldest and largest national Indian organization representing Indian tribes and individuals. On behalf of our 119 tribal governments which we represent, I express strong support for the Indian investment tax incentives and in particular express support for H.R. 1325, the Indian Employment and Investment Act of 1993 as introduced by the Honorable Bill Richardson.

Decades ago when I was growing up we did not have electricity or indoor plumbing. However, today deplorable conditions still exist on Indian reservations, as 20 percent of the Indian homes still do not have toilets and 50 percent of homes still do not have telephones. 1990 census data indicate that of the total American Indian Alaskan native population, the unemployment rate is a little over 38 percent, and currently on Indian reservations the average unemployment is 56 percent.

We believe that employment and investment tax incentives provides us the tools to encourage economic development and investment to support viable tribal economies which is necessary to address and alleviate some of the conditions that we have described. Without tax incentives there is little incentive for private businesses to invest in Indian country.

Reservation lands are often located in isolated areas and far from the center of economic development. Conditions on reservations are similar to that of many Third World countries, extreme poverty and lack of facilities and infrastructure to attract economic development. Sewer systems, electricity, passable roads, lack of telephone, adequate housing and facilities are not readily available.

We have looked at the proposal to create one Indian empowerment zone and five Indian empowerment communities, and we recognize that there is some benefit to this proposal, however, we prefer the approach of H.R. 1325 because of the benefits that will be available to all of Indian country, definitely more than the six reservations that would benefit from the empowerment zone proposal.

Finally, I want to emphasize that there is great need for Indian investment tax incentives. Current Federal policy is one that supports tribal sovereignty and self-determination. To have real self-determination tribal governments need to be economically self-sufficient. Last year Congress supported Indian employment and investment tax credits and we respectfully request you to again approve and support them this year.

Thank you.

[The prepared statement follows:]

TESTIMONY OF RACHEL A. JOSEPH
OF THE NATIONAL CONGRESS OF AMERICAN INDIANS

I want to thank the subcommittee for its invitation to appear today. My name is Rachel A. Joseph, and I am the Interim Executive Director of the National Congress of American Indians. The National Congress of American Indians is the oldest and largest tribal organization in the United States, and I am pleased to be here on behalf of our membership which includes 119 tribal governments.

Last year, Indian Investment Tax Incentives (The "Indian Employment and Investment" tax credits enacted by the 102nd Congress in October, 1992 as sections 1131 and 1132 of H.R. 11, the "Revenue Act of 1992.") were passed by Congress only to be vetoed by President Bush. Today, we again express support for Indian Investment Tax Incentives and in particular, support of The Indian Employment and Investment Act of 1993, HR 1325.

Today I would like to emphasize three points. The first point is that devastating economic conditions exist within Indian Country and the need for Indians to have the tools to create a viable economy. The second point is that the Indian Employment and Investment Act of 1993 is more responsive to the needs of Indian Country compared to the proposal to create one Indian "Empowerment Zone" and five Indian "Empowerment Communities." And finally, I want to emphasize that there is great need for Indian Investment Tax Incentives for all of Indian Country.

POINT I:

Currently, within the boundaries of Indian Country substantial unemployment and extreme poverty are an everyday part of reservation life. In a significant number of reservations, the unemployment rate is over 80%. The Racial Statistics Branch of the Population Division of the United States Bureau of the Census, found in 1990 that, over 38% of the total of reservation and non-reservation American Indians, Eskimos and Aleuts were unemployed. Another grim statistic of the 1990 census, reveals that one-third of American Indians, Eskimos and Aleuts living below the poverty line. The teen suicide rate among Indian teens, is over four times the national average. Sickness and disease is extensive as well: The Indian Health Service has reported that tuberculosis rates among Indians exceeds all other ethnic groups by 400%. 93,000 Indian people are homeless or live in substandard housing. It is important to note that although the United States gives nearly ten billion dollars every year to foreign countries in an effort to improve basic living conditions, more than 50% of all Indian homes do not have telephones and over 20% of Indian homes do not have toilets.

As the Honorable Bill Richardson noted in an April 1993 Commentary in the Los Angeles Times, if unemployment in a city reaches 20%, a national crisis is immediately declared. On Indian reservations, unemployment rates have been consistently over 50%. Congressman Richardson noted that the United States has a federally chartered Overseas Private Investment Corp. to insure U.S. private investment in unstable nations, but no program, offering incentives/assistance for private industry, exists within the boundaries of Indian Country.

Through various treaties and federal law, the federal government has promised to house, feed, educate and provide adequate health care to American Indians in exchange for virtually all Indian lands, and resources. Today we are again asking for assistance, not in the form of federal "handouts", but instead through a program which will allow us to create a viable economy for ourselves.

Generally, there is little incentive for private, non-Indian economic enterprises to invest in Indian Country. Reservation lands are most often located in isolated areas, far from centers of economic development. Additionally, due to the extreme poverty, conditions on reservations resemble those found in many third-world countries. Sewer systems, electricity, passable roads, telephones, and adequate shelter are not readily available in much of Indian Country. Tribes lack many of the facilities that could attract economic development and investment.

The provision of investment incentives, such as those found in HR 1325, would be an important tool to support a viable economy. Throughout history, tax incentives have worked to stimulate stagnant economies because they encourage investment and economic activity in a particular area.

The National Indian Policy Center noted in a 1991 report, that in this time of recession, there is aggressive competition among state and local governments, which also are actively promoting economic development, these governments aggressively compete with each other and tribal governments for new industry and jobs. The state and local governments often use investment incentives as tools to create a better economy. By using investment incentives, state and local governments attract new investments and new economic opportunities in a way that is unavailable to tribes. The savings allowable through use of investment incentives, are often a deciding factor for companies' determination of whether to invest in a particular community.

For Indian tribes, it is extremely difficult to compete for economic development opportunities and new investment because of lack of infrastructure, and other problems which I have already described. HR 1325 would allow tribes the ability to use the tools of investment incentives to attract industry to Indian Country. Tribes desperately need the ability to offer economic benefits to attract private investment entities.

POINT II:

Related to the second point, I wish to emphasize is that there is greater opportunities in Indian Employment and Investment Act of 1993 for all Indian Tribes compared to the proposal to create one Indian "Empowerment Zone" and five Indian "Empowerment Communities." The tax incentives which are offered within the Indian Employment and Investment Act of 1993 allow for immediate reductions in tax liabilities to investors, and therefore strongly encourages the establishment of new industry on a reservation. The Investment Tax Credit provisions are specifically geared towards reservations which have unemployment levels greater than 300% of the national average. H.R. 1325 offers a 10% credit for personal property, 15% for improvements made to the infrastructure within the reservation, and 15% for new construction property. On reservations where the unemployment levels fall between 150% and 300% of the national average, one-half the specified credit would be available. Companies, attracted by the "dollar-to-dollar" tax credits, will be far more inclined to move to Indian Country than without such an investment incentive.

Secondly, the Indian Employment and Investment Act of 1993 would provide employment for Indian people. The purpose of the Employment Credit provision of the bill is to increase Indian employment. During the height of the Great Depression, the unemployment rate for the United States population was between 25 and 30%. Today, the unemployment rate among Indians is over 30%. Among reservation Indians, the unemployment rate is over 50%. These unemployment rates are unacceptable.

The Employment Tax Credit provision will provide crucial assistance. Employers will have strong incentive to hire Native American workers. The ten percent tax credit offered to employers on the basis of qualified health insurance costs and wages paid to Indian employees will encourage employing a higher percentage of Indians within the job-force. An additional incentive would be an employment credit of 30% is offered to reservation employers who have an 85% or greater Indian work force. This "employment credit" is an incentive for greater job creation and Indian employment, within the Indian reservations. Indian unemployment levels are higher than any other group in the nation. Through the employment credit provision of the Indian Employment and Investment Act, this serious unemployment problem is certain to be addressed.

Finally, the Indian Employment and Investment Act is administratively efficient. An administrative agency will not be needed to implement the Indian Employment and Investment Act. The use of tax incentives will allow the economic development policy to be played out in the private sector. Even in a worst case scenario, in which the employment and investment incentives did not work, it would not cost the federal government a significant amount of money. If a bureaucratic system were required to administer the program, then the costs would be substantial.

In summary, the Indian Employment and Investment Act strongly encourages and supports new economic development on reservations, it is a strong incentive to provide for greater Indian employment, and it is administratively efficient. Indian Country economic development has been frustrated because of several factors. The first of which is lack of infrastructure. Tribes, economically impoverished do not have the funds to provide adequate infrastructure improvements. This results in a significant number of unpaved roads, often made impassable due to rain, snow, or other types of bad weather. The second factor to consider is the problems tribes face with "double taxation." Often, state governments will tax non-Indian businesses which are located entirely within Indian reservations. These businesses are already taxed by the tribal governments. The resulting "double taxation" is undesirable to many businesses. Tax incentives, such as those found within H.R. 1325, allowing for higher percentage tax credits than otherwise available to investors in other targeted areas will "even out the playing field" in Indian and non-Indian areas. Without these incentives, Indian tribes will continue to face nearly insurmountable odds in attracting investors to the reservations.

The proposal to create one Indian "Empowerment Zone" and five Indian "Empowerment Communities" creates an economic empowerment for only six tribes. The proposal does not even begin to address the chronic economic and employment needs of Indian Country. The Indian Employment and Investment Act responds to the need of all tribes, the economic-zoning proposal does not.

POINT III:

Finally, related to point three, I would like to emphasize the great need for Indian Investment Tax Incentives within the boundaries of Indian Country. Through the 1975 Indian Self-Determination and Education Assistance Act, the current federal policy towards American Indian Tribal affairs is one which emphasizes Tribal Sovereignty and self-determination. To have real self-determination, Tribal governments need to be economically self-sufficient. To accomplish this, we need the capability to create a self-sufficient economy. H.R. 1325 offers employment and investment incentives which would begin to help us meet our needs and is virtually unavailable under current conditions.

Last year, Congress supported Indian Employment Investment Tax Credits and we respectfully request you to again approve and support them this year.

Mr. KOPETSKI. Ms. Joseph, it is a good thing that we reserved some time in the record for that glowing introduction because my colleague Bill Brewster is now here. I recognize Mr. Brewster.

Mr. BREWSTER. Mr. Chairman, sorry I didn't get here earlier. We had a bill over in the Health Care Subcommittee and we were talking about pharmaceutical care and Medicare for the future, and I think health care is very important to Indian people and all people. But I appreciate the opportunity to visit just a moment about the testimony that Ms. Joseph has made. I have cosponsored the bill she is talking about along with Congressman Bill Richardson, the Indian Employment and Investment Act. I think that is extremely important to what we are doing in the whole reconciliation package, and we proposed this as a substitute for the one particular portion in there in the administration's bill concerning one Indian reservation.

We believe this is a far better approach than the one reservation-type thing. Oklahoma has the largest number of Indian people of any State in the Nation. We have no reservations. We have Indian country. It is extremely important that the wording be correct in what we do in this and that all Indian people have the right to the approach that we are talking about.

We don't believe that geographic areas or anything else are important but Indian people are very important, so we would encourage the committee to look with favor on this legislation that would make some changes in the administration's proposal and certainly appreciate the testimony today of Ms. Joseph.

Thank you.

Mr. KOPETSKI. Thank you, Mr. Brewster. We will now here from the Savings and Community Bankers of America, Mr. Lorenson.

STATEMENT OF EDWARD P. LORENSON, VICE CHAIRMAN, SAVINGS AND COMMUNITY BANKERS OF AMERICA, AND CHAIRMAN, PRESIDENT, AND CHIEF EXECUTIVE OFFICER, BRISTOL SAVINGS BANK OF CONNECTICUT

Mr. LORENSON. Mr. Chairman, thank you for the opportunity to appear today before your subcommittee. My name is Edward P. Lorenson. I am chairman, president and chief executive officer of Bristol Savings Bank in Bristol, Conn. I am here today in my capacity as vice chairman of the Savings and Community Bankers of America.

The Savings and Community Bankers of America strongly supports the amendment proposed by Representative Shaw to create an exemption from the at-risk rules for sales of foreclosed property by federally insured depository institutions. Many banks and thrifts are currently trying to work through substantial portfolios of foreclosure property identified as real estate owned, or REO, on their balance sheets.

In the best of circumstances this REO would be a drain on the capital of the institutions and a drag on the real estate values of their communities. It is inconceivable to me that the tax laws work to make this bad situation worse by denying buyers of REO tax deductions if the bank or thrift finances a sale itself on a nonrecourse basis. It is my understanding that the at-risk rules were made applicable to seller financed real estate sales in 1986 because sales

prices in such transactions are often inflated to generate tax deductions.

The at-risk rules prevent abuse by denying the buyer tax deductions for any expenses in excess of the amount of the down payment in any recourse financing. The buyer will be denied tax deductions for the basis created by nonrecourse financing which he or she would have been entitled to if the property would have been purchased with financing from an independent lender.

This is a harsh result because buyers in perfectly legitimate real estate sales are being denied legal tax deductions, but in reality it is the financial institution selling foreclosure property that are being punished because they are forced to reduce the selling prices of their REO to reflect the loss of tax benefits. This reduction in the amount realized from REO sales reduces the capital of financial institutions and real estate values in general.

Buyers of foreclosed property typically cannot arrange third party financing because the property is very risky. Obviously the bank or thrift had it foreclosed because the previous owner could not make a go of it.

Consequently, financial institutions have no choice but to finance the sale of the REO themselves. Representative Shaw's bill would eliminate this harsh treatment without creating any opportunity for abuse.

FIRREA in 1989 and FDICIA in 1991 have eliminated any opportunity for abuse because of massive restructuring of the banking laws. Federal examiners now scrutinize the REO on the books of financial institutions very carefully. We are required to have real estate appraisals done at the time of foreclosures and done annually.

The four regulators have recently published detailed standards for lending on real estate and lending standards are specifically intended to eliminate abuses on inflated valuations. There is national standards for ethical conduct in the training of appraisers. There are standards with respect to the methodology for appraisal reports which includes the market income replacement cost and certainly a coordination of value, and there are also heavy civil penalties that now can be imposed on appraisers.

It is a very common complaint by regulators as well as financial institutions that the fear of civil liability is causing appraisals to come in too low. Mr. Shaw's proposed amendment creates a responsible and reasonable 10 percent down payment requirement and requires that the loan be made on terms that are commercially reasonable and the same terms as those that would be required by an independent lender.

The fact that the buyer is required to have a real equity stake in the property will provide assurance that the parties really intend the transfer of ownership. Currently financial institutions are unable to sell an REO at its true market value because of the tax detriments imposed on buyers by the at-risk rules. I believe the situation is not only harmful but unnecessary. We think there are enough adequate safeguards in the banking law to prevent institutions from inflating the value of foreclosed property, and we urge your committee to support this proposal.

[The prepared statement follows:]

STATEMENT OF EDWARD P. LORENSON,
PRESIDENT OF BRISTOL SAVINGS BANK OF CONNECTICUT

Mr. Chairman, thank you for this opportunity to appear today before your Subcommittee. My name is Edward P. Lorenson and I am the Chairman, President, and Chief Executive Officer of the Bristol Savings Bank of Bristol, Connecticut. I am here today in my capacity as the Vice Chairman of the Savings and Community Bankers of America. Accompanying me is James E. O'Connor, the SCBA Tax Counsel.

The SCBA is the trade association of the more than 2100 member institutions comprising the savings association and savings bank businesses. The membership includes all types of institutions -- federal and state chartered, stock and mutual.

Description of the Proposed Amendment

I am here today to testify in support of a proposed amendment to the Internal Revenue Code offered by Representative Clay Shaw. His proposed amendment would create an exception from the "at-risk" rules of section 465 of the Code for a non-recourse loan made by a federally-insured depository institution to finance the sale of real estate acquired by that institution by foreclosure or by an instrument in lieu of foreclosure. This exception would be available only where two conditions are satisfied.

First, the nonrecourse financing must be commercially reasonable and on substantially the same terms as would be required by an unrelated third-party lender. This condition is intended to be consistent with the exception from the at-risk rules created for loans from related parties under section 465 (b)(6)(D)(ii) of the Code.

Second, the buyer must be initially "at risk," apart from the exception created by this amendment, for at least 10% of the purchase price. For this purpose the buyer will be initially at risk for the cash and the adjusted basis of any property used as a downpayment and any financing for which he or she is personally liable or for which other property has been pledged.

Description of the At-Risk Rules

The at-risk rules of section 465 limit a taxpayer's "losses" from an activity to the amount that he or she actually risks losing in the activity through recourse financing, as well as any cash and property invested. Section 465(d) of the Code defines a loss for purposes of the at-risk rules as the excess of the deductions allowable for the taxable year and allocable to the activity over the income received or accrued during the year from the activity. In addition, deductions will be allowed to the extent they are out-of-pocket payments. Thus, deductions for such expenses as taxes, insurance, and, to the extent not financed, interest are unlikely to be affected by the rules. In many cases, the only deduction affected by the at-risk rules is likely to be for depreciation.

The at-risk rules apply to individuals, partners in partnerships, estates, trusts, shareholders in S corporations, personal holding companies, and certain closely-held corporations. They were made applicable after 1986 to real estate transactions. This extension, like the creation of the passive loss rules, was a direct attack by the 1986 Tax Reform Act on real estate tax shelters.

An exception is provided to the real estate at-risk rules so that a borrower will be treated as at risk with respect to a nonrecourse real estate loan made by a financial institution. This exception will not apply, however, where the non-recourse loan is made to finance real estate owned by the lending financial institution itself.

Congress had become aware by 1986 that, in many real estate transactions where seller financing was provided on a nonrecourse basis, valuations had been inflated to generate tax benefits. In such transactions there would be either a corresponding offset in the interest rate or, where the rate was not offset, an intention of the parties that the "buyer" would surrender the collateral after using the tax benefits of ownership for some period.

Congress recognized a similar potential for abuse where the lender and borrower are related. Accordingly, the exception for non-recourse financing from financial institutions is also not available where the financial institution lender and the borrower are related (e.g., the borrower owns 10% or more of the financial institution.) But in the case of related party real estate lending, it is actual, rather than potential, abuse that results in the denial of deductions. Where the related parties establish that the non-recourse real estate loan is "commercially reasonable"

and on substantially the same terms as loans made by unrelated persons, the borrower will be considered at risk with respect to the amount of the loan. The commercial reasonableness of a non-recourse loan to a related person will not avoid the application of the at-risk rules, however, where the lender is also the seller.

The Impact of the At-Risk Rules

According to the Wall Street Journal (page B4, June 7, 1993), commercial banks alone hold about $26 billion in foreclosed property and another $33 billion in delinquent property loans. In very many cases, the demonstrated riskiness of this property means that buyers cannot arrange financing from third-parties on reasonable terms. (Almost by definition, in the case of commercial real estate, for at least one prior owner the property has not been viable economically.)

When financial institutions are forced to finance their foreclosure property sales themselves, individual and partnership buyers will price the deal to reflect the loss of tax deductions due to the application of the at-risk rules. Assuming the buyers were to break with commercial custom and provide recourse financing, the deal would also be priced to reflect the increased risk. Even the price paid by regular corporations (which are not subject to the at-risk rules) will reflect the decline in the market value of the foreclosure property created by the at-risk rules. In addition, the decrease in the value of foreclosure property created by the at-risk rules almost certainly has a generalized impact on real estate values.

To the extent that the market value of their foreclosure property is reduced by the application of the at-risk rules, there is a direct reduction in the capital of financial institutions. Ironically, the institutions whose capital condition is most precarious are typically those with the largest portfolios of foreclosure property. I believe that the at-risk rules are reducing the capital of financial institutions and, thus, increasing the need for government intervention and takeovers. This reason alone, apart from their apart from their impact on real estate values in general, is sufficient reason why the usefulness of the at-risk rules in preventing tax abuse must be carefully considered.

The At-Risk Rules Are Redundant in the Tax Law.

I believe that there are other provisions of the tax law that provide adequate protection against financial institutions and sellers, in general, inflating the value of their real estate so that the impact of the at-risk rules on financial institution capital and real estate values is unacceptable. The general imputed principal rules of section 1274 or section 483 should be sufficient to prevent the most likely abuse -- agreements by the buyer and seller to recharacterize interest as principal.

Under the imputed principal rules, if a debt instrument issued in exchange for nonpublicly traded property does not bear adequate stated interest a portion of the principal will be recharacterized as interest. Interest is tested using either the applicable federal rate or 9%, if lower, for all transactions under section 483 and transactions involving seller financing of $2.8 million or less under section 1274. Under Section 1274, installment obligations are tested using the applicable federal rates in a statutory method and two alternative proposed regulatory methods.

The imputed interest rules of section 1274 create an administratively convenient method of assuring that basis has not been overstated in a deferred payment sale by creating a safe harbor. Basis will not be considered to have been overstated by the parties provided that the deferred payments bear interest at least equal to the applicable federal rate. In effect, section 1274 permits the stated or imputed principal amount to be substituted for the buyer's basis in the property in lieu of its fair market value.

Some situations are considered so potentially abusive, however, that imputed principal amount required to be used is the fair market value. Under the general rule of section 1274 if the stated principal amount of the debt instrument exceeds the imputed principal amount there will be insufficient stated interest. Section 1274(b)(3) characterizes all nonrecourse financings as "potentially abusive." The effect of this characterization is that, whenever a deferred payment sale occurs using nonrecourse financing, taxpayers will have to obtain an appraisal or other reliable estimate of fair market value.

The requirement that fair market value be used as the imputed principal amount will expand the application of section 1274 to cover not only those situations where the inflation of value is offset by a reduction in interest rate, but also those where the value of the property is inflated without a reduction of the interest rate because only a transfer of tax benefits is intended by the parties. (Recently published proposed regulations recognize that where a sufficiently large downpayment is made there is no danger that the value of the property will be inflated without a reduction in the interest rate. Under the proposed regulations, a 20% downpayment is required to avoid characterizing a nonrecourse financing as potentially abusive.)

I believe that not only is the potential for abuse in nonrecourse financings adequately addressed by the imputed principal rules of section 1274, but the approach of section 1274 is fairer than that of the at-risk rules. Under the approach of section 1274 taxpayers may be said to be treated as guilty until they establish their innocence of tax abuse--not an unusual approach in the tax law. Under the approach of the at-risk rules, however, the guilt or innocence of the buyer is irrelevant. He or she will be punished by a loss of proper tax deductions to deter tax abuse that is not possible anyway.

Adequate Regulatory Safeguards Are Imposed on Federally-Insured Financial Institutions

In the case of nonrecourse loans made by banks and thrifts to finance foreclosed real estate sales, I believe that because of recent banking law changes there is no longer any significant potential for federally-insured depository institutions to engage in the kinds of abuses that Congress was concerned about when the at-risk rules were made applicable to real estate transactions. The "Real Estate Lending Standards" recently adopted by all the federal banking regulators (OCC at 12 CFR Part 34, Federal Reserve at CFR Part 208, FDIC at 12 CFR Part 365, OTS at 12 CFR Parts 545 and 563) prescribe detailed rules specifically intended to eliminate such abuses as lending on inflated valuations. These real estate lending standards were mandated by section 304 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA). In addition, FDICIA prescribes legal sanctions for officers and directors who engage in such abusive activities.

Specifically with respect to foreclosure property, SAIF-insured thrifts are required to appraise each parcel at the earlier of an in-substance foreclosure or acquisition and at such times thereafter as dictated by prudent management policy. (See 12 CFR section 563.172.) This appraisal is to be performed by a state certified or licensed appraiser where the value of the property exceeds $100,000. Currently, a similar requirement is imposed upon national banks where the value of the property exceeds the lower of 5% of equity capital or $25,000. (See 12 CFR 7.3025(d) and (g).) A new appraisal or a certification that the property's value did not decline must be obtained annually thereafter. (See 12 CFR 7.3025(h).)

The Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA) created appraisal reforms that required states to establish agencies for qualifying appraisers and testing them on a continuing basis. The Office of Thrift Supervision published a comprehensive set of appraisal regulations in 1990 applicable to SAIF-insured thrifts. Under these regulations, all appraisals must be written and must comply with a national standard governing the ethical conduct of appraisers, the process and methodology they employ in developing appraisal reports, and the norms they must follow in presenting their work. (See 12 CFR 564.1 through 564.8.) Substantially identical requirements apply to BIF-insured banks and thrifts.

Probably the most effective constraint on inflated valuations, however, was the inclusion by FIRREA of appraisers in the term "institution-affiliated party." As a result of inclusion in this term, any independent or staff appraiser who "knowingly or recklessly participates in any unsafe or unsound practice which caused, or is likely to cause, more than a minimal financial loss to, or a significant adverse effect on, the insured depository institution" can be subjected to fines not to exceed $1 million per day. (See 12 USC 1813(u)(4) and 1818(i)(2)(D).) The civil penalties to which an appraiser can now be subjected for an inflated appraisal (that, in the hindsight of a regulator, was done knowingly or recklessly) are so dire that it is a very common complaint by financial institutions that appraisers are too conservative.

The Proposed Amendment Is Consistent with the Administration's "Credit Crunch" Initiative

The requirement of a 10% downpayment makes sense, I believe, for several reasons. It is an adaptation of the current regulatory accounting requirement that a 10% downpayment must be received before a financial institution can treat foreclosure property as having been disposed of and institutions are used to dealing with it.

I note in this respect that, in conformity with the Administration's current credit crunch initiative, the four federal regulators of banks and thrifts have pledged to ameliorate the regulatory accounting treatment of foreclosure property because it has been identified as discouraging institutions from providing financing to prospective purchasers. The Office of the Comptroller of the Currency has been the first regulator to implement this pledge by means of a proposed regulation that would conform the regulatory accounting treatment of foreclosure property for national banks to the GAAP accounting standard which is more flexible. (See Federal Register, Vol. 58, May 5, 1993, at page 26695.)

While I agree that conforming the regulatory accounting treatment of foreclosure property to GAAP may be helpful in resolving the credit crunch, the buyer side of the equation must also be addressed. The tax discrimination against buyers created by the at-risk rules also contributes, I believe, to the credit crunch. If the capital of financial institutions is being drained because they must sell foreclosure property below market to offset the buyers' loss of tax deductions due to the at-risk rules, the institutions will have less funds to lend.

The 10% Downpayment Requirement Eliminates Abuse Potential

To eliminate a potential for abuse, the buyers of the foreclosure property should be required to make a substantial downpayment. If the buyers are at risk of losing at least 10% of the purchase price, I believe that they would be unlikely to purchase the property with the intention of using its tax deductions for some period and then abandoning it.

The Proposed Amendment Should Be Revenue Neutral

My view that the proposed amendment is revenue neutral is based on its 10% downpayment requirement and the operation of the at-risk rules. Under the rules the basis for depreciation and the depreciation schedule of the property is not affected. The initial amount at risk, as increased by the income and decreased by the losses from the property, sets a limit on the total amount of depreciation that can be taken.

Given the current real estate depreciation schedules, I am told that it could take six or seven or more years before a buyer who makes a 10% downpayment would have his or her deductions eliminated by the at-risk rules. If we assume for simplicity that the impact of the at-risk rules is offset entirely by a reduction in the selling price, it seems apparent that most real estate developers will only invest in properties with significant rental income to offset the reduced supplement to cash flow provided by depreciation under today's schedules. The rents will increase the initial risk amount. Another factor that will delay the date when the at-risk rules eliminate deductions is the treatment of rental real estate ownership as a per se passive activity under the passive loss rules.

Given these factors, it seems apparent to me that, in today's real estate market, if a buyer makes a 10% downpayment, for at least five years his or her tax deductions will be unaffected by whether the at-risk rules apply or are repealed. If the proposed amendment applies only to transactions entered into in the current year and the buyer is required to risk an amount such that he or she would not lose any deductions by the application of the at-risk rules for at least five years, eliminating altogether the application of the at-risk rules to such transactions should not lose any revenue under the estimating conventions used to "score" the budgetary impact of tax legislation.

Thank you for this opportunity to testify, Mr. Chairman. I would be happy to answer any questions.

Mr. NEAL [presiding]. Thank you. I painfully served on the Banking Committee for 4 years before coming over here to Ways and Means. It is my understanding earlier today that Treasury raised some questions about the safeguards that you make reference to on page 5. I helped to craft that legislation, and it was extraordinarily difficult.

Would you speak specifically to those safeguards as you interpret them?

Mr. LORENSON. I can tell you exactly what we go through as a financial institution when we have a foreclosure action we have to have the property appraised. We have to have, under national banking laws, you have to have it appraised every year; when you sell a property you have to have it appraised again. We cannot book the property as a sale unless there is a 10 percent down payment.

I know the Treasury has raised some objections because they don't think there is enough safeguards. We think that not only are there safeguards, we would suggest and would strongly urge your consideration to put some of this into this legislation, that we follow the banking laws as they are presently designed to make all these safeguards for REO property and the sale of REO property.

Mr. NEAL. You are confident your industry would be receptive to those ideas?

Mr. LORENSON. Very confident. We are dealing with it every day now. We have to go through those appraisal standards, so there is no way that any bank or any financial institution can put an inflated price on a REO property, not only the examiners but the external auditors that come up with your annual audit statements. They are checking all this, too.

Mr. NEAL. And there is certainly considerable scrutiny of those activities by other interests as well, right?

Mr. LORENSON. Oh, yes.

Mr. NEAL. Mr. Hoagland, who served on the Banking Committee with me. Mr. Hoagland.

Mr. HOAGLAND. Mr. Neal, I am interested in Mrs. Roessel's testimony. I have been told, Mrs. Roessel, that the Navajos are not interested in participating in any kind of Indian gaming or any casino-style Indian gaming; is that right?

Ms. ROESSEL. The Navajo Nation right now does not have any gaming activity that they engage in, and the way the Navajo Nation Council is handling that is to observe what is happening. They have put together a study group just to make sure that someone is keeping on top of it in terms of what the developments are, but we don't engage in gaming.

Mr. HOAGLAND. Well, for your own interests you need to do that obviously. I think the points that you make in your statement here as I read through it really underscore what a number of us have been arguing for quite a while, and that is that the needs of Native Americans living on reservations are extraordinary and need to be at the very top of our priority list in terms of achieving economic development. Mr. Richardson has been supporting the bill, I assume you are here testifying in favor of his legislation?

Ms. ROESSEL. Yes.

Mr. HOAGLAND. There are a number of us in the Midwest that are concerned about the spread of Nevada-style casino gaming throughout the country, and in the Midwest now, Wisconsin, Minnesota, South Dakota, all have major gaming facilities, and I think a lot of us are worried about the life-style effect that is having not just on American Indians that live on reservations but also the customers of those establishments, and I am so pleased to see that you are taking the initiative to bring about economic development which in the long range I think will be much more positive in its effect on Indian culture and Indian economic development than would this sort of sudden and what will probably be short-lived interest in casino gaming.

Do you have any reflections on what you all have concluded is best for the Navajo Nation?

Ms. ROESSEL. Gaming?

Mr. HOAGLAND. Do you have any comparisons? What has your experience been with respect to the kinds of economic development that are the most positive?

Ms. ROESSEL. Well, for us what we really need and many other reservations need are labor-intensive industry to come on to the reservation. We have in the Navajo Nation 34 to 50 percent unemployment, depending on the season. It would be important to get industry on to the reservation to help create the infrastructure, the roads and so forth, which is why the proposal of Congressman Richardson to us is very important. It does have that incentive for infrastructure development so that a company would be able to have the incentive to go out and build a road, to build some of the basic necessities needed to engage in business.

For Navajo, we are very fortunate because we have extraordinary natural resources. We have oil, gas, and coal. We experienced the devastating effects of the uranium industry, which is no longer there other than abandoned mines. Half of our income is derived from those energy resources, and obviously those are depletable resources. This is why we are very concerned about having some other means to attract business on to the reservation, which is why with the administration's proposal, although we appreciate that Indian reservations are designated as one Indian empowerment zone and five empowered communities, we think that that only is going to allow six Indian reservations total with having the ability to attract businesses, and have those additional incentives. Yet we have over 500 Indian tribal governments if you include the Alaskan native villages. As such, we really need an equal opportunity tax incentive. And as President Zah has testified, tribal leaders really need those tools.

We are not saying that the incentives are a panacea or are one solution, but we need to try to build up as much as we can to attract businesses. Even though you might have the devastation of East Los Angeles, you have the devastation that we live in on Indian country where we don't have even the basic infrastructure, we don't have electricity, sanitation, schools and so forth, not even Federal Express, so——

Mr. HOAGLAND. What is your view about using casino gaming as a means for bringing about the same end?

Ms. ROESSEL. Well, that is something that our tribe has deferred. We don't have a position. When I have heard Mr. Zah asked that question, he says that it is up to the tribal government in terms of what they think can best meet their circumstances. He has not wanted to be in a position to say yea or nay as to what he personally feels or to make a judgment on other tribes. He understands that without viable economic means that may be the only option for a reservation or tribe. I would obviously have to punt on that. I don't know, NCAI is here, I am sure they have members of gaming tribes and they may be able to answer or elaborate on that.

Mr. HOAGLAND. Miss Joseph, maybe you could talk a little bit about your preference, the form of economic development, whether it be the kind of economic development encouraged by the Richardson bill or the kind of economic development allowed by the Indian Gaming Act of 1988.

Ms. JOSEPH. Our organization supports tribal sovereignty, and the rights of tribes to be self-governing and to make determinations on what is going to happen on their lands and with their people. Consequently, we are very supportive of those tribes that have pursued the option of gaming as a form of economic development and used that revenue to meet the social and educational needs of their community, which they do.

We do, however, recognize that while some tribes engage in gaming, it is not feasible for many tribes because they are located in rural areas where they are not accessible to large populations. Tax incentives and encouraging other options and forms of economic development really needs to be supported.

Mr. HOAGLAND. You concur in the prohibition in the Richardson legislation of using any sort of these economic development tools to advance casino gaming?

Ms. JOSEPH. We recognize that was a compromise that was made last year and we do support the legislation as introduced.

Mr. HOAGLAND. OK. Thank you, Mr. Chairman.

Mr. NEAL. Thank you, Mr. Hoagland. Is there anything else that any members of the panel would like to offer?

Well, our purpose for this day having been accomplished, the hearing will resume on Thursday, June 24, at 10 a.m. in room B–318, and I thank the panelists for their information they shared with us today. Thank you.

[Whereupon, at 2:33 p.m., the subcommittee was adjourned, to reconvene at 10 a.m., Thursday, June 24, 1993.]

MISCELLANEOUS REVENUE ISSUES

THURSDAY, JUNE 24, 1993

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
SUBCOMMITTEE ON SELECT REVENUE MEASURES,
Washington, D.C.

The subcommittee met, pursuant to call, at 10:15 a.m., in room B–318, Rayburn House Office Building, Hon. Charles B. Rangel (chairman of the subcommittee) presiding.

Chairman RANGEL. I apologize for the lateness in the start of this subcommittee. Both Mr. Hancock and I were participating in another subcommittee of the full committee, but we are here.

And today we meet for the third of several days of hearings that we are going to have on miscellaneous revenue issues that have been introduced by Members of the Congress and referred to this subcommittee by Chairman Rostenkowski.

We intend to hear testimony from a variety of public witnesses, and they will address a variety of tax proposals from international business transactions, natural resources, and estate gift issues. All of these proposals were described in the press release that we issued on June 2 and June 11.

Because there are so many witnesses testifying on these miscellaneous items, we will, by unanimous consent, allow all of the written statements to be entered into the record in their complete form. And we are forced once again to ask the witnesses to do a most difficult task and that is to highlight their testimony and have it reduced to 5 minutes. This will allow members of the panel, of course, to ask questions and to clarify some of the issues that they have.

I now ask whether there are any members of the subcommittee that would like to make a statement.

Mr. Hancock.

Mr. HANCOCK. Thank you, Mr. Chairman.

As you know, there is another hearing going on concerning the Caribbean Basin. I would like to apologize to the people that are going to be testifying here because I am going to have to go back to that other hearing.

We do have the records here, and we are going to review all the testimony.

I would like to say that anybody, even though I am not going to be able to stay here, that would like to contact myself or my staff, are certainly welcome to do so.

Thank you very much.

Chairman RANGEL. That is a generous offer.

Any other member seeking recognition?

At this point, the Chair asks unanimous consent that a statement be entered by Congressman Matsui at that point in the record that the subcommittee deals with the foreign tax provisions and natural resource issues. If there is no objection.

The first panel, foreign tax provisions.

For the Investment Company Institute, we will hear testimony from the president, Matt Fink.

From Merrill Lynch, we will have the pleasure of revisiting a dear friend and former professional staff member of the Joint Committee on Taxation, LaBrenda Garrett Stodghill.

Itel Corp., from the hometown of our chairman, Chicago, James Knox, senior vice president, general counsel and secretary. On behalf of the chairman we welcome you once again to Washington.

For Frank Russell Co. and Frank Russell Investment Management Co., Tacoma, Wash. Where is Mr. Russell? Fort Lewis, 1948.

Mr. EGE. Yes, sir, it is still there.

Chairman RANGEL. Warren C. Thompson, chief tax counsel. He is with Karl J. Ege, general counsel with the Frank Russell Co.

We will start with Mr. Fink.

STATEMENT OF MATTHEW P. FINK, PRESIDENT, INVESTMENT COMPANY INSTITUTE

Mr. FINK. Thank you, Mr. Chairman.

I am Matthew Fink, president of the Investment Company Institute, which is the national association of the mutual fund industry.

I am pleased to be here today to testify in strong support of H.R. 1891, the Investment Competitiveness Act of 1993. The bill would eliminate very significant obstacles currently faced by U.S. mutual funds seeking to sell their shares overseas. It would also enhance the flow of benign capital into the United States. The bill reflects both good tax policy and good trade policy.

There is a growing recognition around the world about the benefits of investing through mutual funds. As the middle class continues to grow both in industrialized countries and in developing countries, the popularity of mutual funds can be expected to grow.

If that growth can be channeled into U.S. funds rather than foreign funds, our economy here will benefit. And one benefit derived from selling U.S. funds abroad is enhanced capital formation that would result in the United States from the flow of investment dollars into the U.S. securities markets. Hopefully, this inflow could help maintain low interest rates here and increase the pool of equity capital needed to expand U.S. businesses.

An increased demand for U.S. mutual fund shares will also increase the demand for mutual fund services provided by American fund managers, transfer agents, custodians, accountants and other service providers.

Despite the high quality of U.S. mutual funds, which are the crown jewel of our securities markets, the ability of U.S. funds to gain effective access to foreign investors has been minimal to date, and a significant reason for this failure is the current U.S. withholding tax which acts as a disincentive for foreign investors to acquire shares of U.S. mutual funds.

Generally, interest and capital gains paid by U.S. companies to foreign investors are exempt from U.S. withholding tax. However, dividends paid to foreign investors are subject to U.S. withholding. Since the U.S. tax law currently converts interest income and short-term capital gains realized by mutual funds and paid to investors into dividend income, these amounts become subject to withholding when distributed to foreign investors, even though the underlying source is interest income and capital gain income.

By contrast, U.S. withholding tax is not applied to interest income and capital gain income received by a foreign investor from a foreign mutual fund.

This difference in taxation between a U.S. fund and a foreign fund is a powerful incentive for the foreign investor to invest in foreign mutual funds rather than U.S. mutual funds. Unless U.S. mutual funds can offer foreign investors tax treatment comparable to that offered by foreign mutual funds, U.S. mutual funds will continue to be unable to attract foreign investors.

The bill before you would permit U.S. funds to flow through to foreign shareholders the underlying character of both interest income and short-term capital gains income earned by the fund. Thus, U.S. funds could distribute this interest income and this capital gain income to foreign investors free of withholding.

I ought to emphasize that the bill would not affect the taxation of U.S. investors. For American investors, all the existing current domestic tax law principles would continue to apply as they are today.

I thank you for the opportunity to testify today, and I would be happy to answer any questions.

Thank you, Mr. Chairman.

Chairman RANGEL. You may concentrate on your last sentence for a question after we hear the panel.

Mr. FINK. Thank you.

[The prepared statement follows:]

STATEMENT OF MATTHEW P. FINK,
PRESIDENT OF INVESTMENT COMPANY INSTITUTE

I. Introduction - H.R. 1891 Should Be Enacted

My name is Matthew P. Fink. I am the President of the Investment Company Institute, the national association of the American investment company industry.[1]

I am pleased to be here today to testify in support of H.R. 1891, The Investment Competitiveness Act of 1993. As you know, Congressman Gibbons introduced this bill following a series of hearings held in recent years by the Ways and Means Committee to consider tax law changes that would improve the competitiveness of U.S. industries overseas.

In fact, H.R. 1891 not only would eliminate obstacles that U.S. mutual funds face in the world's increasingly globalized financial markets. The bill would also provide the additional benefit of enhancing the flow of foreign capital into the U.S. capital markets. H.R. 1891 reflects good tax policy and good trade policy because it will eliminate obstacles to effective competition by the U.S. fund industry in the global marketplace. Congressman Gibbons' bill should be enacted.

II. Mutual Fund Sales Are Growing Rapidly Throughout the World

There is a growing worldwide recognition of the benefits of mutual fund investing. For example, since 1987, the growth of mutual funds in Canada has been 279 percent, in France 212 percent, and in Germany 216 percent.[2] For this same period, growth in the U.S. fund industry has been approximately 208 percent. The mutual fund markets of Australia, Italy, India, Mexico and many South American countries have also grown at remarkable rates. We estimate that mutual fund assets outside the U.S. now approximately equal the U.S. total of $1.7 trillion.

Numerous factors indicate that the worldwide potential for further mutual fund growth is substantial. For example, total mutual fund assets, impressive as they are, currently comprise a relatively small percentage of total world financial assets.[3] As the middle-class population continues to grow in both the industrialized and the developing countries around the world, the popularity of mutual funds can be expected to grow.

Along with their growing investment in mutual funds, middle-class investors around the world will increasingly seek global diversity in investing. Moreover, the obvious complexities involved in evaluating worldwide investment opportunities enhance the desirability of making such investment through professionally managed portfolios, i.e., mutual funds.

The sheer size of the global market, including an estimated 320 million people in the European Community countries alone, suggests that tremendous opportunities exist. So too do recently published statistics on savings levels in other countries. In Japan, for example, the personal savings rate in 1990 as a percentage of disposable household income was 14.3 percent, nearly triple the U.S rate of 5.1 percent.

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[1] The Investment Company Institute's membership includes 4,116 open-end investment companies ("mutual funds"), 336 closed-end investment companies and 13 sponsors of unit investment trusts. Its mutual fund members have assets of about $1.665 trillion, accounting for approximately 95 percent of total industry assets, and have over 38 million individual shareholders.

[2] Mutual Fund Fact Book, 33rd Ed., Investment Company Institute, at page 66 (1993).

[3] Financial Systems and Development, World Bank, at page 21 (1989).

III. Selling U.S. Mutual Funds Abroad Would Benefit the U.S. Economy

U.S. mutual funds are an ideal vehicle for attracting foreign investment dollars into the U.S. capital markets. Foreign investment in the U.S., channelled through U.S. mutual funds, is a benign source of capital that will not result in foreign investors acquiring control of U.S. businesses.

A. Increasing Sales of U.S. Funds Abroad Would Expand U.S. Capital Markets

One significant benefit derived from selling U.S. mutual funds abroad is the enhanced capital formation that would result from the inflow of billions of investment dollars into the U.S. securities markets. This inflow could help maintain low interest rates, increase the pool of equity capital needed to expand existing American businesses and promote the creation of new business ventures.

Foreign investment through U.S. mutual funds has the distinct advantage of expanding our capital markets without leading to foreign control of U.S. businesses. The diversification requirements which are applicable to U.S. mutual funds under Subchapter M of the Internal Revenue Code and various provisions of the federal securities laws effectively limit foreign control of U.S. businesses through U.S. mutual funds. In addition, the fundamental investment objectives of most U.S. funds preclude them from investing to obtain control over operating companies. Thus, the sale of U.S. funds abroad would encourage foreign investment in, but not foreign control of, U.S. businesses.

Recent experience suggests that America's success in attracting foreign capital may be faltering. Net foreign purchases of U.S. Government securities totalled $88.806 billion in 1988 but fell to $74.525 billion four years later. Foreign ownership of corporate equity in the U.S. has been stagnant for over four years. Deposits by foreigners in U.S. banks have also remained relatively constant: $733.316 billion at the end of 1990 and an estimated $704.081 billion at the end of March 1993. Overall, capital inflows into the U.S. in the first quarter of 1993 were, at an annualized rate of less than $28 billion, only one eighth of the $206.121 billion recorded in the peak year of 1986.[4] Direct investment in the U.S. by foreigners has also fallen in 1992 to its lowest level since 1983.[5] Removing the barriers to the sale of U.S. mutual funds abroad would increase foreign investment in the United States.

B. Increasing Sales of U.S. Funds Abroad Would Increase the Demand For Ancillary Fund Services Provided By U.S. Companies

Increasing demand for U.S. fund shares abroad will increase the demand for ancillary fund services provided by U.S. fund managers and advisers, transfer agents, custodians, accountants, attorneys and others located in the U.S. Thus, growth in the U.S. mutual fund industry will produce a "ripple effect," causing growth in U.S. fund-related service providers. In contrast, purchases of foreign mutual funds sponsored by foreign advisers or other offshore entities will permit foreign service providers to benefit from the rapidly growing worldwide demand for mutual

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[4] All statistics are from Treasury International Capital Reports, Treasury Department, Office of International Banking and Portfolio Investment (May 26, 1993).

[5] U.S. Department of Commerce, Bureau of Economic Analysis, May 1993.

funds. By permitting U.S. mutual funds to compete abroad, the demand for ancillary fund services provided to U.S. mutual funds by an array of U.S. entities and individuals will increase.

IV. Changes in U.S. Tax Law Are Needed to Enable the U.S. Mutual Fund Industry to Compete in Foreign Markets

A. Foreign Investors Currently Purchase Only Nominal Amounts of U.S. Mutual Funds

Despite the high quality of the U.S. industry's products and services and the attractive growth potential in overseas markets, the ability of U.S. funds to gain effective access to foreign mutual fund investors has been minimal.[6] This stark contrast between the U.S. industry's tremendous success in the domestic marketplace and its experience in foreign markets is a clear sign that there are impediments to effective international competition.

The U.S. withholding tax laws, which give foreign investors a substantial tax disincentive to purchase U.S. mutual funds, are the focus of our testimony today. We believe that these tax consequences arise primarily from the application of domestic principles of taxation that were developed almost 60 years ago for an industry which, at that time, was marketed only to U.S. investors. If U.S. funds are to compete effectively in the increasingly global financial markets, we must eliminate the disincentives to invest in U.S. mutual funds that are created by U.S. tax law.

B. Sales of U.S. Mutual Funds Abroad Are Disadvantaged by U.S. Tax Law

Under current U.S. tax law, U.S. funds are disadvantaged by tax withholding provisions that do not apply to comparable foreign funds.

Generally, portfolio interest income and any realized capital gains paid to foreign investors are exempt from U.S. withholding tax. However, distributions of dividends to foreign investors are subject to U.S. withholding tax. Under current U.S. tax law, interest income and short-term capital gains realized by U.S. funds are converted into "dividend" income when distributed. Thus, foreign investors who purchase U.S. funds are subject to U.S. withholding tax on their interest income and short-term capital gain. By contrast, U.S. withholding tax is not applied to interest income or capital gains received by a foreign investor through a foreign mutual fund.

This difference in taxation is a powerful incentive for foreign investors seeking to purchase mutual funds to favor non-U.S. funds. Unless U.S. funds can offer foreign investors tax treatment comparable to that offered by foreign funds, U.S. funds will continue to be unable to attract foreign investment.

V. H.R. 1891 Would Improve the International Competitiveness of U.S. Mutual Funds

A. H.R. 1891 Would Provide Comparable Treatment For Foreign Investors in U.S. Mutual Funds and in Foreign Mutual Funds

To achieve comparable tax treatment for the foreign investor choosing between a U.S. or a foreign mutual fund, we urge this

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[6] While net sales of long-term stock and bond funds reached $197.006 billion in the U.S. in 1992, sales outside the U.S. were nominal. Foreign shareholders own less than one-quarter of one percent of U.S. fund shares.

Subcommittee to support enactment of H.R. 1891, The Investment Competitiveness Act of 1993. This legislation includes provisions designed to make the tax treatment of foreign investors in U.S. mutual funds comparable to the tax treatment afforded to foreign investors in foreign mutual funds, thus eliminating the competitive disadvantage created for U.S. funds by existing tax law.

The bill would permit U.S. funds to flow through to all shareholders the character of the interest income being distributed. In addition, U.S. funds would be permitted to flow through to foreign investors the character of any short-term capital gains being distributed. Thus, U.S. funds could distribute to foreign investors interest income and short-term capital gains free from withholding to the same extent currently permitted for foreign mutual funds.

B. H.R. 1891 Would Provide Comparable Treatment For Foreign Direct Investors and Foreign Investors in U.S. Mutual Funds

A fundamental principle underlying the taxation of U.S. mutual funds has been to provide tax treatment for the mutual fund investor comparable to that provided to direct investors in securities. H.R. 1891 is consistent with this principle.

The foreign direct investor in U.S. securities, like the foreign investor in a foreign mutual fund, is generally not subject to U.S. withholding tax on either interest or short-term capital gain. Thus, by flowing through interest and short-term capital gain to the foreign investor in a U.S. mutual fund free from withholding, H.R. 1891 would provide the foreign investor in a U.S. mutual fund with tax treatment comparable to that provided to the foreign direct investor in U.S. securities.

C. Taxation of U.S. Mutual Fund Shareholders Would Not Be Affected

It is important to note that none of these provisions would affect the taxation of U.S. investors in U.S. mutual funds. Current domestic tax law principles would remain intact for U.S. investors.

VI. Explanation of Specific Provisions

A. Interest Flow-Through

The Internal Revenue Code imposes a 30 percent withholding tax on certain distributions of income, including dividends and some types of interest income, paid to all foreign investors. The 30 percent withholding rules do not apply, however, to certain types of interest, including "portfolio interest", which is generally defined as interest on obligations issued in registered form after July 18, 1984. In addition, tax treaties often reduce the withholding rate for both dividends and interest to a lower rate, such as 15 percent. Many tax treaties further reduce the withholding rate to zero for interest paid to foreign investors, without regard to whether the interest qualifies for the portfolio interest exemption from withholding.

As discussed above, under current law, when a U.S. mutual fund receives interest income and distributes that income to shareholders, the distribution is considered dividend income rather than interest. This "dividend" income is, therefore, subject to withholding tax when received by a foreign investor, even if the income would be exempt from withholding if received by a foreign investor directly or indirectly through a foreign mutual fund.

To provide comparable treatment for foreign investors in U.S. mutual funds with foreign direct investors and foreign investors in foreign mutual funds, the bill would permit U.S. funds to treat as interest income exempt from withholding tax when distributed the following: (1) interest on obligations issued in registered form; (2) original issue discount, market discount, and acquisition discount; and (3) bank deposit interest.

In addition, the bill characterizes all interest which flows through a U.S. mutual fund as interest (rather than as a dividend). Thus, foreign investors in U.S. funds who receive such interest often would not be subject to withholding tax at the rate applicable to dividends, if the investor is from a country that has entered into a treaty with the United States. Instead, the investor could take advantage of any lower tax rate afforded to interest under the treaty.

The bill appropriately recognizes that a foreign investor should not be able to invest through a U.S. mutual fund and avoid the current law restriction that prohibits a foreign investor who owns at least ten percent of the equity of a corporation (a "ten-percent shareholder") from treating as portfolio interest any interest received on a bond issued by that corporation. The bill prohibits this circumvention of the portfolio interest rules by not exempting from tax interest from a corporation which flows through a mutual fund to a ten-percent shareholder in that corporation.[7] This provision thus prevents a foreign investor who controls a foreign corporation from arranging to receive the corporation's profits as portfolio interest not subject to U.S. withholding rather than as dividends which are taxable.

B. Short-Term Capital Gain Flow-Through

Under present law, short-term and long-term capital gains realized by foreign investors are generally exempt from withholding tax. Because long-term capital gains realized by a U.S. mutual fund retain their character when distributed to shareholders as long-term capital gain dividends, foreign investors in U.S. mutual funds are not subject to withholding tax on these gains. However, short-term capital gains realized by a U.S. mutual fund are currently distributed as ordinary income dividends, and are, therefore, subject to the withholding tax when distributed to foreign investors.

To provide treatment comparable to that afforded to foreign direct investors in U.S. securities and to foreign investors in a foreign mutual fund, the bill would exempt from withholding tax short-term capital gain received by a foreign investor through a U.S. mutual fund. Moreover, the amount of a fund's short-term capital gain would be calculated in the same way as every other investor calculates short-term capital gain, i.e., by subtracting from the sales proceeds the appropriate cost basis, without any reduction for expenses. Also, as under present law, any net capital loss or net short-term capital loss attributable to transactions occurring after October 31 of a year would be treated as arising on the first day of the next taxable year for purposes of the mutual fund distribution requirements under Code section 4982.

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[7] Given the difficulties that funds would have in ascertaining whether a mutual fund investor owns 10 percent or more of the equity in a company in which the fund invests, the fund's withholding obligation is limited to situations where it knows of the fund investor's ownership interest in the underlying company.

C. Estate Tax Exemption

Under current law, foreign direct investors in U.S. securities have certain U.S. estate tax advantages compared to foreign investors in U.S. funds. In particular, a foreign direct investor is not subject to U.S. estate tax on either (1) debt obligations whose interest is eligible for the portfolio interest exemption from withholding tax or (2) certain amounts deposited in banks. For estate tax purposes, these assets are deemed not to be property within the United States. However, a foreign investor is subject to U.S. estate tax under current law if these otherwise exempt assets are held indirectly through a U.S. mutual fund.

The bill would provide foreign investors in U.S. mutual funds with treatment comparable to the foreign direct investor by providing that fund shares will be property "not within the United States" to the extent that the underlying fund assets would have been exempt from estate tax if held directly by the investor. Thus, for example, if 50 percent of the underlying assets would be assets exempt from U.S. estate tax if held directly by a foreign investor, only 50 percent of the value of a foreign investor's shares in that fund would be subject to U.S. estate tax.

VII. Conclusion

H.R. 1891 would provide the U.S. mutual fund industry with the opportunity to market, on a competitive basis, a product in which we are the world's leader. Worldwide consumer acceptance of mutual funds by a growing middle class has created a strong potential for selling U.S. mutual funds abroad and attracting foreign capital into the United States. Enactment of H.R. 1891 will permit the realization of this potential.

* * *

On behalf of the Investment Company Institute, I would like to thank the members of this Subcommittee for the opportunity to testify in support of H.R. 1891. I would be glad to respond to any questions you may have.

Chairman RANGEL. Merrill Lynch, Ms. Stodghill, counsel.

STATEMENT OF LABRENDA GARRETT STODGHILL, COUNSEL, MERRILL LYNCH & CO., INC.

Ms. STODGHILL. Thank you, Mr. Chairman and members of the committee.

I am LaBrenda Garrett Stodghill, a principal at Liz Robbins Associates. I am here today to testify on behalf of Merrill Lynch and its affiliates.

Merrill Lynch supports the proposal to amend section 956 of the code in a way that would eliminate an anomaly that permits controlled foreign corporations to make loans to U.S. corporations but prevents the making of such loans to noncorporate U.S. persons. And noncorporate persons would include individuals, partnerships, trusts and estates.

As you know, Mr. Chairman, section 956 was enacted to prevent U.S. shareholders from paying themselves disguised tax-free dividends, and this could occur where a controlled foreign corporation accumulates earnings abroad free of U.S. tax and then makes those untaxed earnings available to its shareholders by engaging in a transaction such as making a loan to the U.S. shareholder.

Section 956 prevents this result by treating a controlled foreign corporation's investment in U.S. property as a deemed dividend to the U.S. shareholder. An investment in U.S. property would include the obligation that arises when a loan is made to a U.S. person.

Now, back in the context of the 1976 Tax Reform Act, the Ways and Means Committee recognized that no untaxed earnings are made available to a U.S. shareholder when a loan is made to an unrelated U.S. person. And if you look at the 1976 committee reports, you will see that the discussion is framed entirely in terms of loans to unrelated U.S. persons. There is no distinction made between corporate and noncorporate persons.

The statutory language, however, only permits loans to be made to U.S. corporations. This discontinuity in current law prevents U.S.-owned companies from competing with their foreign counterparts. German or Japanese companies are free to lend into the United States to noncorporate persons. They not only do not pay taxes in their home country, they are also outside the reach of section 956.

Now this problem in current law should be eliminated, corrected in any event, but the proposed amendment is made even more necessary by the pending legislation that would exacerbate the problem under current law. As you know, Treasury proposed a provision to expand the scope of section 956 and the Ways and Means Committee included that provision in its budget reconciliation recommendations.

Now, the Ways and Means Committee did add language to the Treasury proposal requiring Treasury to study the very issue that would be addressed by the proposal before the committee today, and I would respectfully submit that Treasury, having initiated a proposal to extend the reach of section 956, can reasonably be charged with having done all of the studying that is needed.

In Treasury's testimony before this committee, the only concern identified related to the absence in the proposal of a provision similar to the rule in current law that prevents a controlled foreign corporation from making a loan to a related domestic corporation. Merrill Lynch would agree that a comparable limitation should be added to the proposal. The proposal is intended to provide the same treatment for loans to noncorporate persons that now applies only to loans made to corporations.

I want to add that any remaining concerns regarding the scope of the proposal can be addressed in a way that at least takes care of the immediate problem faced by U.S.-owned companies that are prevented from competing effectively with their foreign-owned counterparts. What we have in mind is limiting the proposal to cover companies engaged in the business of lending money.

The code already contains several definitions of financial services entities. An example is the provision limiting foreign tax credits in section 904 of the code.

That is my testimony, Mr. Chairman, and, again, I thank you for this opportunity to present Merrill Lynch's views on the need to eliminate this artificial tax distinction in section 956.

Chairman RANGEL. I assume that in your full statement you have suggested language that addresses Treasury's objection to the legislation?

Ms. STODGHILL. Yes, Mr. Chairman.

Chairman RANGEL. OK, we will work with you on that.

[The prepared statement follows:]

STATEMENT
on
THE PROPOSAL REGARDING THE TREATMENT OF CERTAIN INVESTMENTS OF CONTROLLED FOREIGN CORPORATIONS IN U.S. PROPERTY
before the
SUBCOMMITTEE ON SELECT REVENUE MEASURES,
COMMITTEE ON WAYS AND MEANS
on behalf of
MERRILL LYNCH & CO., INC. AND ITS AFFILIATES
by
LaBrenda Garrett Stodghill
Principal, Liz Robbins Associates

June 24, 1993

Mr. Chairman and members of the Committee, my name is LaBrenda Garrett Stodghill. I am testifying today on behalf of Merrill Lynch & Co., Inc. and its affiliates ("Merrill Lynch"). I thank the Chairman and the Committee for the opportunity to present Merrill Lynch's views on the proposal that would rationalize the rule that permits a controlled foreign corporation ("CFC")[1] to make loans to unrelated U.S. corporations (under Section 956(b)(2)(F) of the Code) while the recognition of income is triggered if loans are made to unrelated noncorporate persons.

The legislative history of Section 956 of the Code does not explain why this artificial distinction was created. As a result of current law, U.S.-owned companies suffer a competitive disadvantage relative to foreign-owned firms that are free to make loans to noncorporate U.S. persons. The amendment to broaden the scope of the Section 956 operating rules, which Treasury proposed and the Ways and Means Committee recently adopted,[2] exacerbates the problem under current law. For these reasons, Merrill Lynch would respectfully request that the treatment of loans to unrelated U.S. corporations be extended to loans to unrelated noncorporate persons.

Legislative Background

Generally, the U.S. tax on a CFC's profits is deferred until remitted to a U.S. shareholder in the form of a dividend. Section 956 of the Code was enacted to prevent U.S. shareholders from circumventing the general rule by obtaining the use of a CFC's earnings without payment of U.S. tax, through loans and similar transactions.

As originally drafted, Section 956 treated a CFC's investment in any "United States property" (including loans to unrelated U.S. corporations)[3] as a dividend to its U.S. shareholders. Thus, a CFC engaged in lending activities was (effectively) prohibited from conducting its ordinary business with U.S. borrowers.

The anomaly created by the 1976 Tax Act. As part of the 1976 Tax Reform Act, however, the Congress provided exceptions from the definition of United States property. The legislative history of the 1976 amendment provides, in part:

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[1]A controlled foreign corporation is any foreign corporation more than 50 percent of the vote or value of the outstanding shares of which is owned, directly or indirectly, by U.S. shareholders. Section 957(a) of the Internal Revenue Code of 1986, as amended (referred to herein as the "Code").

[2]See Section 14232 of H.R. 2264, the House version of the pending Reconciliation Bill.

[3]Section 956(b) of the Code defines "United States property" to include tangible property located in the United States, stock of a domestic corporation, and obligations of a United States person, inter alia.

> Present law is very broad as to the types of property which are to be classified as U.S. investments for purposes of this rule. For example, the acquisition by the foreign corporation of stock of a domestic corporation or obligations of a U.S. person (even though unrelated to the investor) is considered an investment in U.S. property for purposes of imposing a tax on the untaxed earnings to the investor's U.S. shareholders.
>
> The committee believes that the present scope of the provision is too broad....In the committee's view a provision which acts to encourage, rather than prevent, the accumulation of funds offshore should be altered to minimize any harmful balance of payments impact while not permitting the U.S. shareholders to use the earnings of controlled foreign corporations without payment of tax.[4]

While all of the applicable reports explained the amendment as applying to U.S. persons (without limiting the exception to U.S. corporations) the statutory language did not extend the exception to loans made to noncorporate U.S. persons.[5]

The discontinuity in current law is best illustrated by the following examples:

> (1) Loans made by a CFC to each of two unrelated U.S. corporations would not be treated as a deemed dividend, but a loan made to a partnership formed by the same two corporations would trigger a deemed dividend.
>
> (2) Similarly, a loan made to an S corporation would not trigger a deemed dividend, but a loan made to the shareholders of the S corporation would give rise to a deemed dividend.

The 1976 legislative history gives no indication of why CFC loans to noncorporate persons were not provided with similar treatment.[6] Certainly, however, loans to noncorporate persons would not provide a U.S. shareholder any greater use of a CFC's earnings then loans made to corporations.

The Urgency Created by the Administration's 1993 Tax Initiative As proposed by the Administration, the Ways & Means Committee adopted a provision to broaden the scope of the Section 956 "deemed dividend" rules. On its own initiative, the Ways and Means Committee added statutory language requiring Treasury to conduct a study of the appropriate tax treatment of investments by CFCs in obligations of U.S. persons other than corporations.[7]

If the scope of Section 956 of the Code is to be broadened, I respectfully submit that the

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[4]S. Rep. No. 938, 94th Cong., 2d Sess., 225-226 (1976).

[5]The exception in Section 956(b)(2)(F) of the Code provides that "the term "United States property" does not include the stock or obligations of a domestic corporation which is neither a United States shareholder (as defined in section 951(b)) of the controlled foreign corporation, nor a domestic corporation, 25 percent or more of the total combined voting power of which, immediately after the acquisition of any stock in such domestic corporation by the controlled foreign corporation, is owned, or is considered as being owned, by such United States shareholders in the aggregate."

[6]Significantly, the 1976 legislative history includes the statement that the adoption of the exception for loans to corporate persons had little or no revenue impact (see p. 228 of S. Rep. 938).

[7] See Section 14232 of the pending Reconciliation Bill.

operating rules are working by ending the anomalous treatment of CFC loans to noncorporate U.S. persons.

The Proposal Is Intended to Eliminate the Discontinuity in Current Law

The proposal before the Committee was intended to extend the present law treatment of CFC loans to U.S. corporations to loans made to unrelated noncorporate U.S. persons. In Testimony you received on June 22, 1993, Treasury noted that the proposal "does not simply treat loans to noncorporate and corporate U.S. persons identically," as the proposal would except loans made by a CFC to a noncorporate U.S. entity that is 25-percent or more owned by 10-percent U.S. shareholders of the CFC.

While the current statutory language only refers to 25-percent owned domestic corporations (with no mention of 25-percent owned noncorporate entities) Merrill Lynch would be happy to work with this committee to develop a comparable limitation under the proposal. The basic proposal is simply to remove the current law anomaly by allowing CFCs to make loans to unrelated U.S. individuals, partnerships, trusts and estates, without triggering U.S. tax on the CFC's un-repatriated earnings.

International Competitiveness

In addition to correcting the anomaly described above, this proposal will also benefit the U.S. economy by removing a needless tax impediment to the flow of worldwide capital to its most productive uses, thereby making an additional source of credit available to U.S. noncorporate borrowers.

The sophistication of U.S. investors and the globalization of financial markets means that individuals, partnerships, trusts and estates who had previously only dealt with U.S. lenders are now seeking funding from around the world. U.S. companies are expanding overseas to help bring the resources of the international market to U.S. investors. The effect of the current definition of United States property is to prevent these companies from economically competing in this line of business.

So too, the current definition of United States property puts U.S. companies at a competitive disadvantage relative to foreign controlled companies which have made substantial inroads on U.S. financial institutions. Not only can Japanese, German, U.K. and French companies make loans to U.S. individuals without being subject to current tax in their own countries, but the deemed dividend rule of Section 956 has no application.

The United States cannot afford to cede its dominion over the worldwide capital markets. Thus, anomalous tax impediments such as the treatment of CFC loans to noncorporate U.S. persons should be removed.

Conclusion

Thank you again Mr. Chairman for this opportunity to bring this matter to the attention of the Committee on Ways & Means. I along with knowledgeable officers and employees of Merrill Lynch are available to work with the Committee to address this anomaly in the Code.

Chairman RANGEL. Mr. Knox.

STATEMENT OF JAMES E. KNOX, SENIOR VICE PRESIDENT, GENERAL COUNSEL AND SECRETARY, ITEL CORP., CHICAGO, ILL.

Mr. KNOX. Thank you, Mr. Chairman.

Chairman RANGEL. Chicago. How are things in Chicago? Are you from Chicago?

Mr. KNOX. I am indeed, sir.

Chairman RANGEL. You live in Chicago?

Mr. KNOX. I do, indeed.

Chairman RANGEL. You know the chairman?

Mr. KNOX. I do, indeed.

Chairman RANGEL. Take as much time as you want.

Mr. KNOX. Thank you, Mr. Chairman. I think that concludes my remarks.

I also know that we have a fine Congressman who is represented on this committee, and I thank him for being here to show his interest in our matter.

Chairman RANGEL. Which one is that?

Mr. KNOX. Congressman Reynolds.

Chairman RANGEL. Was he referring to you?

Mr. REYNOLDS. Must have been.

Mr. KNOX. I am the senior vice president and general counsel and secretary of Itel Corp., which is headquartered in Chicago. I am here today to testify on a proposal to protect foreign financial service companies from the harsh consequences of the PFIC rules.

As you know, Mr. Chairman, these are the rules that were designed to shut down abusive foreign mutual fund schemes. Itel holds an interest in a foreign company which, in turn, owns an interest in financial service companies, and these companies are desirous of raising capital, equity capital in the United States.

These financial service companies are regulated as banks in their foreign countries. They perform exactly the same services as banks in their foreign countries except they do not take deposits. In short, they are like many commercial banks are in the United States.

The PFIC rules already recognize that banks should not be subject to the PFIC rules, and now this committee and the Treasury Department is preparing to exempt security companies from the application of the PFIC rules.

If one is going to compare these foreign financial service companies to banks which are already exempt or to compare them to security companies which are proposed to be exempt, it is quite clear that they are much closer to banks than the security companies.

Now, I am not saying that the security company exemption is not a wise one. I am saying that we also need to recognize that the world of banking has changed and that today financial service companies compete with banks, perform the same services as banks and should be treated like banks.

In not providing such an exemption for financial foreign service companies, we are precluding them from using the U.S. capital markets to raise equity because of the uncertainty in the minds of the U.S. investors in how the PFIC rules apply, and the result of this is an unfair impact on the U.S. capital markets. In support of

that, NASDAQ, the second largest security market in the world, has filed a letter with this committee in support of the proposal to exempt financial service companies from the rules of the PFIC provisions.

I understand that Treasury is reluctant to permit this exemption. I am puzzled as to why.

Chairman RANGEL. Administrative problems.

Mr. KNOX. Well, the banks are already exempted. This looks like a bank. It talks like a bank. It quacks like a bank. I don't understand their problem.

Chairman RANGEL. That would help if you understood the problem and assisted us in resolving whatever problems they have.

Mr. KNOX. We would love to have that opportunity, Mr. Chairman, because we think it is unfair to subject these companies which compete directly in their home markets with banks to the disadvantage of being unable to raise capital in the United States.

Chairman RANGEL. They have not opposed you on the merits.

Mr. KNOX. We think it is unfair to the U.S. capital markets.

Chairman RANGEL. They haven't opposed you on the equity.

Mr. KNOX. Well, then we will get there with your help.

Chairman RANGEL. And with your help.

Mr. KNOX. That concludes my statement. Thank you.

[The prepared statement and attachment follow:]

STATEMENT
on
THE PROPOSAL TO ALLOW FOREIGN CORPORATIONS ENGAGED IN FINANCING AND CREDIT SERVICES A PASSIVE FOREIGN INVESTMENT COMPANY EXCLUSION COMPARABLE TO THAT AVAILABLE TO BANKING AND INSURANCE ACTIVITIES UNDER CURRENT LAW
before the
SUBCOMMITTEE ON SELECT REVENUE MEASURES, COMMITTEE ON WAYS AND MEANS
by
James E. Knox
Senior Vice President, General Counsel & Secretary
Itel Corporation

June 24, 1993

Mr. Chairman and members of the Committee, my name is James Knox. I am Senior Vice President, General Counsel and Secretary of the Itel Corporation ("Itel"), on behalf of which I am here today.

My testimony addresses the proposal to allow active foreign financing companies an exclusion from the Passive Foreign Investment Company (or "PFIC") rules, comparable to the exclusion for banks and insurance companies under current law.

Itel supports the view that current law should be amended to place non-U.S. controlled active foreign financing companies ("Active Foreign Financing Companies") on the list of businesses eligible to receive regulatory relief under Treasury regulations. There is no question that current law reaches far beyond the scope of the offshore mutual fund schemes that prompted the Congress to enact the PFIC rules. I would like to explain that Active Foreign Financing Companies are even less "passive" than the companies covered by the proposed exception that has already been agreed to. In that regard, I will comment on the testimony that Treasury gave before this subcommittee yesterday. Finally, I would like to focus your attention on the "trade" implications of the PFIC regime: The potential application of the PFIC rules to Active Foreign Financing Companies hinders access to the U.S. equity market, resulting in the export of this business to foreign markets.

The Basic Policy Underlying the PFIC Rules

When the PFIC rules were enacted in 1986, the Congress intended to eliminate a tax advantage enjoyed by U.S. taxpayers who invested in passive assets through foreign mutual funds.[1] Under prior law, U.S. investors in foreign mutual funds could avoid current taxation and reap the benefit of preferential capital gain rates for the fund's ordinary earnings.[2] The goal of the PFIC regime was to put U.S. investors in foreign mutual funds in parity with U.S. investors in domestic mutual funds.

The definition used by the Congress to determine PFIC status is a narrow one that looks only to the composition of a corporation's income and assets.[3] The Congress recognized, however, that certain foreign corporations generate "passive

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[1] See "General Explanation of the Tax Reform Act of 1986," prepared by the staff of the Joint Committee on Taxation, 1021, 1023 (May 4, 1987) (referred to herein as the "1986 Blue Book").

[2] See Baldwin, "Games Big People Play," Forbes, Nov. 7, 1983, p. 88; Marcial, "Big Returns, Small Taxes Attract Investors to Offshore Mutual Funds," Wall Street Journal, March 26, 1981.

[3] Under the general rule of Section 1296(a), a foreign corporation is a PFIC if either (1) 75 percent or more of its gross income for the taxable year is "passive," or (2) the average percentage of assets (by value) producing or held for the production of "passive income" is at least 50 percent.

income" (such as interest) due to the nature of their business activities. Thus, the 1986 legislation provided exceptions for the obvious candidates -- viz., banking and insurance activities.[4]

In addition to the statutory rules for banks and insurance companies, the Statement of Managers in the Conference Report on the 1986 legislation expressed the expectation that "bona fide underwriters of securities [would] be excluded from classification as a PFIC."[5] The banking and insurance exceptions, as well as the Conference Report language regarding underwriters of securities, evidence a basic policy of excluding corporations holding "passive" assets as an integral part of an active trade or business.

Unintended Targets of the PFIC Rules

Because the focus in 1986 was on foreign mutual funds, taxpayers were slow to recognize the breadth of the PFIC legislation -- that is, the potential application to taxpayers other than investors in foreign mutual funds.[6] Since 1986 it has become clear that current law is too broad in that it captures legitimate businesses that are unintended targets of the PFIC rules.

Consider the example of a foreign corporation engaged in providing financing and credit-related services (an "Active Foreign Financing Company") the activities of which are limited to:

(1) making personal, mortgage, industrial, or other loans to unrelated persons (including companies and individuals);

(2) purchasing, selling, discounting, or negotiating to unrelated persons notes, drafts, checks, bills of exchange, or other evidences of indebtedness;

(3) providing charge and credit services, or factoring receivables obtained in the course of providing such services, to unrelated persons;

(4) entering into finance leases with unrelated persons; and

(5) disposing of property used in an activity described in (1)- (4) to unrelated persons.

Significantly, the activities I have described would not be considered "passive" for other tax purposes (for example, the foreign tax credit limitations applicable to domestic financing companies).

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[4]Under current law (section 1296(b)(2)(A)) "passive income" does not include any income derived in the active conduct of a banking business by an institution licensed to do business as a bank by the United States, or to the extent provided in regulations, other corporations so engaged. Similarly, "passive income" does not include any income derived in the active conduct of an insurance business by a corporation that is predominantly engaged in such business and would be subject to U.S. tax under the regime applicable to insurance companies if it were a domestic corporation.

[5]H.R. Rep. No. 841, 99th Cong., 2d Sess. II-644 (1986) (referred to as the "1986 Conference Report').

[6]See, e.g., Stodghill, "Applying PFIC Rules To RICs Can Cause Double Taxation" The Journal of International Taxation (July/August 1991) 100 (explaining how the PFIC rules penalize investors in domestic mutual funds, the very taxpayers whom the Congress looked to as models for the proper treatment of PFIC shareholders).

Consider also that the Active Foreign Financing Company derives more than 90 percent of its income from persons located in, and is resident in and subject to the full taxing jurisdiction of, its country of incorporation, the government of which issues operating licenses and supervises the business. Further, the country of incorporation is not a tax haven country and is a full treaty partner with the United States (including a tax information exchange agreement that would allow the U.S. Treasury Department to obtain information necessary to verify the Active Foreign Financing Company's activities). In addition, the Active Foreign Financing Company has correspondent relationships with the largest U.S. companies engaged in similar businesses, and stock in the company is traded on the only stock exchange in the country of incorporation.

Notwithstanding the bona fide business described above, the Active Foreign Financing Company would risk the potential application of the PFIC rules if its shares were sold in the United States.

Impact on U.S. Securities Markets

The potential application of the PFIC rules to Active Foreign Financing Companies also has the effect of denying these companies access to U.S. securities markets (and, consequently, denying U.S. investors investment opportunities).

As explained by the NASDAQ Stock Market -- which lists the securities of 4,100 domestic and foreign companies and is the second largest securities market in the world -- this "denial of access" hobbles U.S. markets in competing with foreign securities markets for listings of strong foreign companies. Moreover, uncertainty in the minds of the investing public with respect to the possible application of the PFIC rules limits the marketability of shares that are listed on a U.S. market.

For the Record, I have attached to my statement a copy of a letter from NASDAQ to Chairman Rostenkowski, supporting the proposal to provide regulatory authority for Treasury to sort out the circumstances in which Active Financing Companies could be excluded from the PFIC rules.

An Opportunity To Take Corrective Action in the Pending Reconciliation Bill

As you know, Mr. Chairman, the Administration recognized that certain foreign corporations that generate interest income due to the nature of their business activities should be excluded from the PFIC rules. The Ways & Means Committee adopted the Administration's proposal by removing securities dealers from the PFIC regime,[7] but no provision was made for Active Foreign Financing Companies.

Treasury's Testimony Fails to Articulate a Substantive Reason for excluding Active Foreign Financing Companies from the Relief Granted to Securities Dealers. In testimony before this

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[7]The Ways & Means Committee restricted the rule for securities dealers to U.S. shareholders owning at least ten percent of the voting stock on an individual basis -- and more than 50 percent in the aggregate -- of controlled foreign corporations, "to insure that the exception cannot be used by portfolio investors to avoid the PFIC rules." WMCP: 103-11, "Fiscal Year 1994 Budget Reconciliation Recommendations of the Committee on Ways & Means (May 18, 1993) p. 256. I would point out that no similar limitation applies to banks and insurance companies, and-- as explained below -- relative to securities dealers, there is considerably more overlap between the activities of Active Foreign Financing Companies and banks.

subcommittee on June 22, 1993, Treasury's Assistant Secretary for Tax Policy stated that the proposal to provide regulatory authority for Active Foreign Financing Companies "raises major administrative problems." Presumably, this is a reference to the fact that Treasury is certainly capable of distinguishing between PFICs and Active Foreign Financing Companies on a case-by-case basis but is reluctant to take this approach. I respectfully submit that a reference to "administrative problems" is not a sufficient response to the substantive unfairness faced by Active Financing Companies.

I am concerned that the subcommittee may have been left with the impression that the Administration's proposal for securities dealers -- without similar relief for similarly situated companies -- is justifiable on the grounds that securities dealers have a Subpart F exclusion. Treasury also testified that "the PFIC provisions eliminate the benefit of deferral for U.S. persons investing in foreign investment funds, [and that] the current and proposed PFIC exceptions are intended to permit certain active businesses to retain deferral, to the extent that the income would not otherwise be picked up under Subpart F of the Internal Revenue Code. I would like to "clarify" Treasury's statement regarding the relationship between the anti-deferral rules of Subpart F and the proposed exception to the PFIC rules for securities dealers. The fact is that interest income received by a securities dealer is not eligible for deferral under Subpart F. Thus, Treasury obviously concluded that the absence of a Subpart F exception for interest income should not present a barrier to PFIC relief.

There is no apparent tax policy reason to provide regulatory relief for certain financial services companies, while excluding others that bear even a closer resemblance to banks. Regarding the distinction between securities dealers and other financial services companies, Treasury's testimony notes that these are "very difficult lines to draw and [they] think that with the addition of the proposed exceptions the appropriate lines will have been drawn." I would like to point out that the line Treasury has drawn for securities dealers covers financial entities that hold the very same assets that one would expect an investment fund to hold. By comparison, with particular regard to the current law exception for banks, the assets and activities of Active Foreign Financing Companies bear a much closer resemblance to banks than to investment funds.

Conclusion

I would respectfully request that this subcommittee recommend that Treasury be provided with whatever authority is deemed necessary to insure that Active Foreign Financing Companies are appropriately excluded from the PFIC rules, similar to the current law rule for banks.

ATTACHMENT

THE NASDAQ STOCK MARKET
NEW YORK · WASHINGTON · LONDON · PALO ALTO

NASDAQ

June 16, 1993

The Honorable Daniel Rostenkowski
United States House of Representatives
Washington, D.C. 20515-1305

RE: The Subcommittee on Select Revenue Measures Hearings on Miscellaneous Tax Issues

Dear Chairman Rostenkowski:

The Nasdaq Stock Market supports the proposal to modify the Passive Foreign Investment Company ("PFIC") rules that relate to foreign corporations actively engaged in the business of financial and credit services (item 15, under the "Foreign Tax Provisions" section of the June 2, 1993 Press Release). Nasdaq is the second largest securities market in the world and lists the securities of 4,100 domestic and foreign companies, more than all other U.S. stock markets combined.

The PFIC rules were enacted as part of the 1986 Tax Reform Act to respond to abuses on the part of US investors in highly publicized offshore mutual fund tax shelters. The PFIC rules cover an area much broader than the limited offshore mutual fund investment companies that they originally targeted and extend to cover foreign finance corporations in non-tax haven countries that are actively engaged in the business of financial and credit services.

The goal of the PFIC rules was to put US investors of passive assets through foreign corporations in parity with US investors in passive assets through domestic investment companies. The PFIC rules were not intended to apply to a foreign corporation engaged in the active conduct of a trade or business. The regime chosen by Congress for determining PFIC status is narrow in the sense that it looks only to a corporation's income and assets to determine its PFIC status. This regime, however, results in an overly broad "shotgun" approach with harsh and unfair consequences to corporations that happen to be engaged in an active business that generates what is generally considered passive-type income.

This tax treatment results in these companies being unwilling to enter the US financial markets. This unwillingness denies access to excellent foreign companies to US investors because they can not purchase the companies in US markets. This unwillingness also hobbles US markets such as the Nasdaq Stock Market in competing with foreign securities markets for listings of strong foreign companies. These companies will thus increasingly look to markets outside the US to raise equity capital, eroding the primacy of US financial markets and the tax revenue that comes from trading in those markets.

Because we understand there to be no revenue cost to the proposed regulatory authority to modify the rules, and current regulation extends much beyond its original purposes, eliminates access to US financial markets, and opportunities for US investors, we see little justification for the continuation of the current regulatory scheme. We believe that a narrowly tailored active financing exception to the PFIC regime would provide access to the US equity capital markets for many active foreign financing companies while at the same time preserving the enforcement of the tax policies underlying the PFIC rules -- preventing income deferral and recharacterization for US persons investing in pooled investment-type vehicles.

We therefore request your favorable consideration of the proposal to modify the Passive Foreign Investment Company rules to provide regulatory authority for the exclusion of foreign corporations that are actively engaged in the business of financial and credit services.

Sincerely,

Richard G. Ketchum
Executive Vice President

Chairman RANGEL. Mr. Fink, Treasury believes that H.R. 1891 could provide better treatment to foreign investors in U.S. mutual funds than our present treaties provide for U.S. investors in foreign funds, and that was their major concern.

We have asked Treasury to give their views, as you might suspect, to all of the proposals in front of us, and we would have to respond to Treasury as we move forward in this legislation. And you could help, all of you, once you understand what the objections are, in helping us think through them.

Mr. FINK. Yes, we received notice of their objections, and we think we have a solution to it. Most of the countries with which we have income tax treaties have treaties with one another. We have prepared a matrix which we will show that the problem is theoretical and not real. But we will be happy to work with Treasury and the subcommittee on resolving it.

Chairman RANGEL. I am sorry, Mr. Ege. I overlooked your team. You may proceed.

STATEMENT OF KARL J. EGE, GENERAL COUNSEL, FRANK RUSSELL CO., TACOMA, WASH., AND FRANK RUSSELL INVESTMENT MANAGEMENT CO., ACCOMPANIED BY WARREN THOMPSON, CHIEF TAX COUNSEL

Mr. EGE. Fine. Thank you, Mr. Chairman.

Members of the committee, my name is Karl Ege. I am general counsel of the Frank Russell Co., a leading global asset consultant and investment management firm headquartered in Tacoma, Wash. I am accompanied today by our chief tax counsel, Warren Thompson.

I am here to testify in favor of H.R. 1891, the Investment Competitiveness Act of 1993. In our view, enactment of this legislation is critical for U.S. mutual funds to become truly competitive investment products in the global marketplace.

Over the years, Russell has gained a reputation as a premier global asset consultant. We currently provide investment strategy consulting on nearly $500 billion of investment assets to over 200 clients worldwide, including the domestic pension plans of General Motors, IBM, AT&T and Boeing as well as similar institutions overseas.

Additionally, we serve as investment managers for over $14 billion of collective investment funds, including mutual funds and commingled employee benefit plans. We have developed an international reputation as an innovative leader in the management of collective investment funds.

Our unique portfolio management technology offers clients a multistyle, multimanager investment strategy which is designed to minimize risks, maximize diversity and sustain above-benchmark yields. This has become increasingly popular to overseas investors, particularly pension funds and insurance companies.

Also, recently, we have seen increasing activity among individual retirement plans overseas as governments of those nations, following the lead of the United States, are turning to defined contribution plans as a method of providing funded retirement security for their citizens.

Unfortunately, as currently structured, the Internal Revenue Code creates a disincentive to the purchase of U.S. mutual funds by these investors overseas. As we have heard today, the up to 30 percent "export tax" which is placed on U.S. mutual funds makes them noncompetitive. This is particularly true for institutional investors who often base their decision on yield spreads of just a few basis points or hundredths of a percent.

Because of the unattractiveness of U.S. mutual funds, foreign investors have turned with increasing frequency to funds that are based in tax-favored jurisdictions such as Luxembourg, Ireland, Bermuda, Cayman Islands and others in order to invest their portfolios in U.S. securities. One of the principal reasons for this is because of the withholding tax.

We have polled institutional investors worldwide, and they have told us that U.S. mutual funds are otherwise high on their list of investment alternatives. The reasons are obvious.

As Mr. Fink has stated, this industry is the crown jewel of the American securities industry. We have an unparalleled commitment to investor protection through our securities regulation scheme for mutual funds. U.S. mutual funds use advanced investment technology. They have the best accounting and custodial capabilities and by far the best client-servicing capabilities.

A recent example that faced us illustrates this point.

Last year, we were approached by a Canadian investment institution to prepare a set of funds for them to sell to their individual retirement account clients. At first blush, our existing mutual fund, the $4 billion of mutual funds we had in the United States, appeared to be good candidates. But after review it became clear, because of withholding tax, that these would not work. So we were required to set up a clone set of funds in Canada in order to market U.S. securities to these accounts.

Those funds became effective in January of this year, and we have already garnered over $100 million into those Canadian funds. Even though the funds are invested substantially in U.S. securities, they employ Canadian accounting, custodial, and trustee recordkeeping services. We pay investment management fees to Canadian managers, and our Canadian affiliate pays Canadian corporate income tax on its earnings in Canada.

This is but one example of a likely scenario that will play out over time.

We cannot ignore the fact that some foreign jurisdictions have actually enacted magnet legislation to attract the fund business to their countries. A recent example is Ireland, which enacted legislation which created pure passthrough tax treatment for funds located there and then significantly lowered the income tax rate for fund management companies located in Ireland. This creates a double incentive to locate the fund's business there.

The success of the U.S. mutual fund industry is recognized by investors throughout the world. Yet the current tax environment effectively prevents this industry from exporting its product. If H.R. 1891 is adopted, it will help create a worldwide market for U.S. mutual funds, thus further encouraging the flow of international capital into U.S. investments.

To us, the Frank Russell Co., H.R. 1891 makes sound business policy and trade sense. We appreciate the opportunity to testify before the committee, and we look forward to any questions you may have.

[The prepared statement follows:]

TESTIMONY OF KARL EGE
FRANK RUSSELL COMPANY

I. INTRODUCTION

My name is Karl Ege and I am General Counsel for the Frank Russell Company. The Frank Russell Company is a privately held company headquartered in Tacoma, Washington. I appear before the Subcommittee today to testify in favor of H.R. 1891, the Investment Competitiveness Act of 1993. In our view, enactment of this legislation is critical if the U.S. mutual fund industry is going to become a truly attractive investment market for global investors.

Russell is recognized as one of the premiere global money managers and pension consulting firms in the world, providing investment strategy consulting worldwide to such institutional investors as GM, IBM, AT&T, XEROX, Boeing, UAL, Unilever, Shell, Monsanto, and others. Other institutional investment clients include Rolls Royce, Dai-ichi Life, Yasuda Fire & Marine, Marks & Spenser, and Lend Lease Corporation (Australia).

Russell employs nearly 1,000 people in the United States, and also has offices in Toronto, London, Zurich, Sydney, and Tokyo. The company serves as investment manager for over $14 billion of collective investment funds, including mutual funds (otherwise known as regulated investment companies or "RICs"), common trust funds, commingled employee benefit funds, and private investment partnerships.

Russell has developed an international reputation as the technology leader for the fund industry; we sit at the cutting edge of investment technology. Our unique portfolio management technology provides a multi-style, multi-manager investment strategy to minimize risk for investors while maximizing diversity.

We have found, in our experience around the world, that the U.S mutual fund industry is the most technologically advanced in the world. This, in turn, allows it to be the most cost efficient in delivering its services to clients. The U.S. tax law, however, is creating an impediment to exploitation of that expertise in world financial markets.

II. CURRENT TAX RULES

The Internal Revenue Code (the "Code") creates such a disincentive by imposing a withholding tax on fund distributions that does not apply in the case of comparable foreign-based funds or to direct investments in the United States by foreign investors. In effect, the Code characterizes interest income and short-term capital gains distributed by a mutual fund as dividend income. When received by a foreign investor, this dividend income is subject to a 30 percent withholding tax. Tax treaties may reduce this rate to 15 percent or less for residents of treaty countries.

Interest income

The Deficit Reduction Act of 1984 generally repealed the 30 percent withholding tax for portfolio interest paid to foreign investors on obligations issued after July 18, 1984. Tax treaties between the United States and a number of foreign countries also exempt interest paid to foreign investors from the withholding tax.

- **Because interest income is characterized as dividend income when it is distributed by a RIC, the portfolio interest exemption and reduced treaty rates do not apply; therefore, such income is subject to withholding tax when received by foreign investors.**

Short-term capital gains

- **A RIC must characterize short-term capital gains as ordinary income dividends, and such income is subject to withholding tax when received by foreign investors.**

In direct contrast, if a foreigner invests directly in U.S. securities, in a unitrust partnership, or in a foreign mutual fund, such short-term capital gains income would not be subject to withholding tax.

Estate tax

A foreign investor is not subject to U.S. estate tax on certain amounts deposited in banks and debt obligations where the interest is eligible for the portfolio interest exemption from withholding tax.

- **A foreign investor is subject to U.S. estate tax if these otherwise exempt assets are held indirectly through a RIC.**

III. CURRENT U.S. TAX LAW CREATES A MAJOR IMPEDIMENT TO FOREIGN INVESTORS

Based on its investment manager research, evaluation, and recommendation activities, as well as on other investment advisory services rendered to large pools of capital worldwide, Russell is keenly aware of the current practices of global investment managers. Global institutional investors and the managers who invest the funds for those pools of capital use U.S.-based mutual funds only sparingly for their pooled investments. One of the principal reasons
they do not use U.S. mutual funds is the withholding tax on dividends and short-term gains.

The U.S. withholding tax provides a disincentive for foreign investors for two reasons -- it effectively imposes an export tax on the U.S. mutual fund industry, making U.S.-based funds less attractive from a pricing standpoint; and it creates an administrative burden for foreign institutional investors.

Large, institutional investors have a broad choice of investment vehicles worldwide. It has been our experience that these investors will not hesitate to move investment assets wherever necessary to obtain the highest after-tax yield available at their particular risk-tolerance level. The U.S. withholding rate of 30 percent reduces yields for U.S. mutual funds to levels below world market rates, thus creating a substantial impediment to U.S. funds in attracting foreign investors.

In many cases these foreign investors could be entitled to a refund of the withholding tax paid. However, the administrative burden and the loss of the use of the funds for some time period (at least six months) outweigh the expected yields. Thus, the foreign investment in U.S. securities is achieved through other means.

Foreign investors can avoid the withholding tax by investing directly in U.S. securities. However, our experience is that foreign investors, particularly institutional investors, prefer to employ highly experienced professional investment managers to diversify their investments overseas through the use of "pooled" vehicles. Recently, Russell conducted a survey of its potential investment clients in Europe. We learned that, in general, those investors prefer a pooled vehicle such as a mutual fund for their global investment strategies. This is no surprise. Pooled investments represent the most efficient way to diversify a portfolio across multiple markets and among several currencies. However, because the Code imposes a tax penalty in the form of the 30-percent withholding tax, those investors generally go elsewhere to access the global markets.

This has resulted in the dramatic increase in institutional funds located in such tax-favored jurisdictions as Luxembourg, Ireland, Bermuda, and the Cayman Islands. Many of the funds created in these jurisdictions invest in U.S. securities; foreign-based institutional investors find these funds attractive because their investments are not subject to the U.S. withholding tax.

IV. HOW THE INVESTMENT COMPETITIVENESS ACT OF 1993 WOULD WORK

Interest income

The proposal would allow interest income earned by a RIC to flow through to foreign shareholders as interest income. In general, interest-related dividends would pertain to interest earned by the domestic RIC from: 1) obligations issued in registered form; 2) short-term (183 days or less) original issue discount obligations; or 3) bank deposits. Interest-related dividend distributions generally would be exempt from the withholding tax.

In addition, a RIC could designate distributions as "taxable-interest dividends." These dividends generally would be treated as interest payments not eligible for exclusion from withholding but, rather, eligible for treaty withholding rates for interest

Short-term capital gains

The proposal would allow RICs to designate short-term capital gains income as short-term capital gains dividends. Short-term capital gains dividends received by foreign investors generally would be exempt from the withholding tax.

Estate tax

A foreign investor's shares in a domestically controlled RIC would not be treated as property within the United States and, therefore would not be subject to U.S. estate tax, in the proportion that would have been exempt from estate tax if held directly by the investor.

Effective date

The bill would apply to taxable years of RICs beginning after the date of enactment.

V. THE RUSSELL EXPERIENCE

We have found in our discussions with target investors throughout the world that the first fund of choice for a foreign investor is one based in its own country. The second choice, if all other things were equal, would be investment in U.S. funds, for the following reasons:

- The U.S. system of regulation is unparalleled in its commitment to investor protection.
- The U.S. fund system uses the most advanced investment management technology, including the best accounting and recordkeeping knowledge and expertise.
- The U.S. mutual fund industry has by far the best marketing and client servicing capabilities.

Until 1980, U.S.-based institutional investors had very few, if any, investments outside the United States. Today, these funds invest close to 15 percent of their assets in overseas equity and debt instruments. Similarly, institutional investors in foreign countries, such as

those in the United Kingdom, Japan, and Switzerland, are also increasing their investments outside their home country. These investors include insurance companies, banks, trusts, pension funds, reinsurance pools, central banks, and government entities.

Russell's recent experiences in Canada exemplify this trend, as well as the impact of the U.S. withholding tax. In 1992, Russell entered into an arrangement to provide a series of investment funds to be marketed to the individual retirement account market in Canada by a Canadian brokerage. The U.S. withholding tax made Russell's existing U.S. mutual funds unattractive investment vehicles for Canadian investors.

Russell was thus forced to create a new Canadian-based family of funds that are essentially "clones" of existing Russell U.S.-based mutual funds, solely for the purpose of providing a tax efficient pooled investment vehicle to Canadian investors who wish to invest a substantial portion of their retirement portfolio in U.S. securities. These funds became fully operable in January 1993, and have grown to over $100 million (Canadian) in assets in less than six months.

One reason these funds are so attractive is because, increasingly, foreign investors are attracted to Russell's "multi-style, multi-management" investment approach. This investment approach is particularly attractive to investors with a long-term asset/liability management focus, such as pension funds, individual retirement plans, and insurance pools. In using the investment technology it has developed over the last 25 years advising some of the world's largest investment pools, Russell is regarded as being on the cutting edge of the global investment business. This proprietary technology and "know how" represent a quantum lead over anything else available in the global market.

Yet, these funds -- managed in Canada but invested in the U.S. securities, other foreign securities, and Canadian securities -- employ Canadian accounting, custodial, trustee, and recordkeeping services and pay investment management fees to selected Canadian investment managers. Russell's Canadian affiliate pays Canadian corporate income tax on its earnings from this operation.

If H.R. 1891 had been in place at the time these funds were organized, there would have been no need for Russell to create this separate set of "clone" funds in Canada.

It is also worth noting that some foreign jurisdictions have actually enacted "magnet" legislation in order to attract the pooled investment business to their countries. A recent example of this trend occurred in Ireland, which enacted legislation creating pure "pass-through" treatment for funds located there, and significantly lowered the income tax rate for investment management firms that conduct funds operations in Dublin. Such foreign legislation thus creates a double incentive to locate fund business off shore.

V. POLICY ISSUES RELATING TO H.R. 1891

Competitive Considerations

U.S. mutual funds, such as those sponsored by the Frank Russell Company, should be placed on a level playing field with foreign mutual funds. The international funds business is highly competitive and marked by very narrow profit margins. Often, mere basis points separate the bidders for institutional investment business. The U.S. fund industry, if it could compete on level ground with foreign funds, would no doubt use its efficiencies, and the contributions of technology to returns on investment, to great advantage in attracting significant foreign capital. As the U.S. tax law is currently written, however, companies like Frank Russell cannot compete--the foreign investment dollar is left to a foreign fund, or to the investor to invest directly in U.S. securities, with little or no benefit in the form of diversification, other than full use of derivative securities.

The Frank Russell funds, and others like them, are blocked out of the competition for international investment dollars by virtue of the U.S. tax law.

Neutrality of Tax Law in Investment Decisions

Investment by foreign investors in U.S. securities may be accomplished in several different ways: directly, or indirectly, through foreign or U.S. vehicles. The U.S. tax law currently favors direct investment or indirect investment through foreign funds. The U.S. tax law compels a particular form of investment by foreign investors. We do not believe that appropriate tax policy is served by the current tax structure. The tax law should be neutral with respect to its impact on investment decisions. We believe that such tax neutrality would permit taxpayers such as the Frank Russell Company to exploit fully the technological and strategic advantages developed over the years.

Application of the 1984 Act Policy

In the Deficit Reduction Act of 1984, Congress exempted from U.S. withholding tax certain payments to foreign direct investors and exempted investments in the underlying obligations from U.S. estate tax. Congress enacted these provisions to promote capital formation and substantial economic growth in the United States. This bill would continue to foster capital formation and economic growth by providing wider access for U.S. mutual funds to the more than $1 trillion dollars in foreign investment dollars currently lodged in foreign mutual funds.

VI. IN CONCLUSION

During the last decade, the U.S. mutual fund industry has become one of the most profitable and growing portions of this country's service economy. U.S. mutual fund assets now total about $1.7 trillion. It seems natural that such a thriving domestic industry be allowed to flourish on an international level as well. Yet, the current tax environment prevents this industry from exporting its product. H.R. 1891 would create a worldwide market for U.S. mutual funds, thus further unleashing the flow of international capital into U.S. investments. For the Frank Russell Company, H.R. 1891 makes perfect sense, from a business and policy perspective.

Chairman RANGEL. Before the chair recognizes Mr. Thomas, I would like to say to this panel as well as those that will testify that you wouldn't be here if your proposals were not considered to have merit. And you do know that they are not law because there are some problems.

And Ms. Stodghill indicated that she knew the problem that the Treasury had, and it would be helpful to this committee that, notwithstanding what is in your written statement, if you would address that problem. It could save us a lot of time in having to ask whether you thought about it and whether or not you have any suggestions.

Ms. Stodghill, of course, has language that would provide some limitation. Mr. Fink, I assume you would join with Mr. Knox, with all of his knowledge in the field, and help Treasury to resolve their administrative problems.

So that, before I ask for questions from the rest of the panel, it is my pleasure to recognize the distinguished gentleman from California and veteran senior member of this committee, Mr. Thomas.

Mr. THOMAS. Thank you, Mr. Chairman. It is a pleasure to return to my former subcommittee with the chairman.

And I assume the statement directed at the panel applies to the members as well, that the offerings that we propose have merit, but I know they are not without problems.

One of them is revenue, and we have a number of revenue offsets. The problem is that it is a moving target, as the chairman knows. The ones that I thought I could use when the reconciliation bill left the House have been absorbed to a very good extent by what went on in the Senate, and they may reappear in conference, so I am keeping an eye on the revenue sources. But, obviously, according to the rules, we will provide revenue for any of the changes if they are considered to be meritorious enough to be accepted.

One of the changes—and I ask unanimous consent that my written testimony be put in the record that I want to focus on is one that the administration does not oppose, and that is an increase of the special use valuation limit from $750,000 to $1.5 million. It hasn't been increased since 1981. It is one of those areas in which you would hope that there would be some enlightened indexing of numbers, but since there isn't we have to periodically come back and make adjustments.

Treasury does oppose my other proposal concerning the unitary tax in California and the court cases associated with it. Treasury currently has some discriminatory, in my opinion, treatment of companies that are located in the United States and have foreign subsidiaries. They are treated differently than foreign companies with subsidiaries in the United States. My proposal corrects this discrimination. We believe it is meritorious and would like to have you look at it.

The last proposal deals with closely held corporations in the leasing business, which we believe are not treated equitably.

With that, Mr. Chairman, I would like to thank you and the committee for allowing me to make this presentation in the middle of hearing testimony about other areas that need to be looked at.

There are a number of inequities currently present in the Tax Code. If we could connect them, hopefully, we can look forward to

the day that we can get some stability in the code. Until that time, I hope you will take a look at some of my suggested changes, Mr. Chairman. Thank you.

[The prepared statement and attachment follow:]

THE HONORABLE BILL THOMAS
(21st District, California)
Before The Subcommittee on Select Revenue
June 24, 1993

I appreciate this opportunity to explain the proposals on the Subcommittee's hearing agenda which I have authored. The Subcommittee has a daunting array of issues in front of it and I will be pleased to provide as much information as possible in order to make your assessment of my proposals easy.

One of my growing concerns is about the preservation of farm land and opportunities for young farmers. To aid in the process, I introduced H.R. 1411 earlier this year. The bill is simple: it raises the "special use" valuation limit from $750,000 to $1.5 million per decedent. The Treasury Department has stated that it does not oppose raising the special use valuation limit and I hope we will be able to do so.

The estate tax needs to be reexamined if we are serious about removing impediments to entering the business of farming. The continuing decline in the number of farms is directly related to the growing difficulty young farmers have in starting operations. A recent GAO report shows potential new farms confront extremely high start-up costs and low returns on investment. The report cites an example in the livestock industry where it can take an investment of $1 million to produce an income of $40,000--a return of about 4% if everything goes right. For young people trying to decide on a career, that will not be very attractive unless we make it easier for them to to assume control of the family business.

Because of the difficulties farm families face in transferring assets, H.R. 1411 has generated a great deal of interest. The American Farm Bureau and and California Cattlemen's Association support the bill. They recognize the importance of the estate tax in passing farms from generation to generation. In spite of today's special use valuation and unified credit, families can see farms broken up for sale so estate taxes get paid.

Just take a look at some farm values and you'll easily see why we need to continue adjusting the special use valuation. Cattlemen value a cow-calf unit at $1,500 and can easily have 300 animals in a heard. If they graze their animals, they need about $3,000 in land per unit. This means a viable farm operation will already have over $1.3 million in value before we start looking at equipment, structures or other assets. Other crops pose the same problem. An acre of table grapes can be worth $8,000 to $10,000, pistachios $13,000 and peaches and nectarines $8,000 to $10,000. Those production-based values, not what a farmer might receive as urban growth, make property attractive for real estate development. These are values before we start looking at the value of equipment and some of that equipment can be extremely expensive. For example, a four-row cotton picker can cost between $150,000 and $200,000.

Congress last seriously changed the special use valuation in 1981, raising the valuation from $500,000 to $750,000 and making a number of other improvements. The explanation for those changes remains an excellent reason for improving the special use deduction today: as Joint Committee on Taxation explained it, the intent was to preserve family farms and other closely-held businesses by limiting estate tax valuations based on property's uses, not fair market value. For farm families trying to move land between generations, this is still an important matter. The value of land devoted to farming can be significantly less that the land's value in real estate development.

If we give farm families a higher limit, we can accomplish two relatively important goals. We can preserve agricultural lands which create far more attractive habitat for wildlife than urban areas do. We can keep farm families in agriculture.

Beginning farmers face high entry costs. Increasing the special use valuation will give families a chance to pass farms between generations instead of forcing them to sell farm assets to meet the estate tax burden they may face.

A doubling of the deduction is in line with what has happened in the economy since the $750,000 level was set in 1981. Gross Domestic Product is 54% higher today, consumer prices are 56% higher, and labor costs are 44% higher. Unless the special valuation is increased to reflect changes in our economy and provide a margin of protection for family farmers, the deduction will protect less and less property as families try to preserve their farms in the future.

The bill does not change the rigorous restrictions on using the valuations. Families would have to keep property in agricultural use for 10 years. A family member must actually participate in farming the land; ceasing to use property in agriculture means the family will have to pay additional estate taxes. The bill also helps families attempting to keep small businesses intact because they will also be able to employ the expanded special use deduction, subject to the same rules they have to follow today.

Another of my recommendations, allowing renewable energy credits to be applied to alternative minimum tax liability, falls in the "natural resources" area. While I am pleased by the Committee's action in last year's energy bill to make the geothermal and solar credits permanent and to provide a production-based credit for wind power, we need to go a bit further by making these credits fully applicable to alternative energy investors' alternative minimum tax liability. I have proposed this adjustment in prior years, and believe it remains a necessary step.

Contrary to the Treasury Department's assessment of the renewable credits, there is a very good reason for allowing the credits to be applied to alternative minimum tax liability: the credits do not provide the incentives Congress intended.

The alternative minimum tax is not a new problem for the solar, geothermal and wind industries. When you examine the testimony of the alternative energy groups, you will find that the uncertainty of the tax credits' availability and the alternative minimum tax were among the key factors preventing them from easily obtaining capital. We have solved one tax problem but the alternative minimum tax is still a barrier to renewable energy development.

Without adjustment, the alternative minimum tax problem will continue to plague these industries. The geothermal industry's experience, for example, is that the alternative minimum tax is almost always triggered by investment in geothermal resources. These can be extremely costly ventures. Even the production-based wind credit creates this problem. Many wind projects have such large depreciation expenses that the credits cannot, under present law, be used until the project is in its tenth year. The wind industry has found that the alternative minimum tax discourages potential investment because many potential investors are already subject to the alternative minimum tax and are reluctant to add to their burdens.

The best way to resolve this matter is to make the renewable energy credits fully applicable to taxpayers's alternative minimum tax liability. I hope you will join me in making such a change this year.

I also hope you will join me in supporting H.R. 1410, my bill to provide U.S. companies competing abroad with a full deduction for taxes they pay to states. This is not a new matter for our Committee. In fact, a panel of industry witnesses testified in favor of my bill in 1991. It was endorsed by several trade groups, including the National Association of Manufacturers, U.S. Chamber of Commerce, Chemical Manufacturers

Association, Pharmaceutical Manufacturers Association, American Electronics Association, Petroleum Equipment Suppliers Association, U.S. Council of International Business and the American Petroleum Institute. The National Governors Association, Committee on State Taxation of the Council of State Chambers of Commerce and the Multi-State Tax Commission also supported the bill. Because this is still a problem for American firms, and because the current regulations still encourage U.S. companies to relocate or allocate resources on the basis of tax rather than economic considerations, I hope you will join me in passing H.R. 1410 this year.

As some of you will recall, the U.S. Supreme Court has ruled that states can use formulae that impose a tax on a company's world wide income under certain conditions. Because of retroactive regulations adopted by Treasury, these taxes are not, as a practical matter, fully deductible.

The regulations indirectly limit the deduction of these taxes by manipulating a company's foreign tax credit limitation. To prevent foreign taxes from reducing tax on U.S. source income, the credit is limited to a percentage of a company's pre-foreign tax credit U.S. tax liability. Essentially, this forces a company paying state taxes under a world wide income formula to allocate some of those taxes to its foreign income, producing non-creditable "excess" foreign tax credits.

These are discriminatory rules, applying only to U.S. firms with foreign operations. U.S. subsidiaries of foreign companies get to deduct all such tax payments. U.S. corporations competing with such firms have an additional cost of doing business because they are, in effect, unable to fully deduct their state income taxes. It even affects U.S. companies competing here at home because corporations operating in "formula" states have higher after-tax costs than their competitors in other states.

The treatment of these taxes is not even consistent with the way we treat other kinds of payments. Treasury has adopted a rule for charitable contributions that ought to be the rule in the area of state taxes. Charitable donations are deductible from U.S. income if the donations are to be used here. That theory ought to apply to state taxes as well, making Treasury's opposition to my bill difficult to understand. Anyone who has dealt with a state taxing authority can easily recognize the importance of making your payments. If a company does not do that, the state locks its doors and seizes company assets. State taxes are directly tied to a company's ability to do business, perhaps more so than charitable contributions. Nevertheless, the Treasury rules treat some state taxes as "foreign" tax payments.

Companies should not have to allocate capital on the basis of federal tax rules. H.R. 1410 solves the problems created by the current rules by providing that all deductions for state and local corporate income and franchise taxes are allocated to U.S. source income for foreign tax credit purposes. The legislation will yield a full deduction for state corporate income taxes. The bill addresses a competitiveness problem we have thrust on American companies through the Internal Revenue Code, a problem we should resolve as soon as possible.

Finally, I hope we can deal with this year the treatment of closely-held corporations' passive losses from equipment leasing activities. The treatment of these leasing companies creates some of the same biases the passive loss rules have caused in the real estate field. As you have already heard, there appears to be a simple way to resolve this dilemma.

The passive loss rules effectively prevent closely-held C corporations from applying their losses to portfolio income. True, the companies can offset actively earned income with passive losses, but losses which cannot be used this way must be capitalized. What the rules create is a competitive disadvantage for companies that are in the leasing business. Other leasing firms do not face this situation.

Publicly-traded C corporations can apply losses from their leasing businesses to earnings on working capital, allowing them greater flexibility in pricing their leases and providing them with some diversification of income sources as a protection against economic difficulties. The Internal Revenue Code does not apply the passive loss rules to these firms. The rules thus discriminate against the closely-held corporation even though its leasing activities are performed in the same way leasing activities are performed by its competitors. The only distinction I see is that a per se rule treats leasing by closely-held firms as a passive activity.

What needs to be done is to provide a clear rule that gives closely-held leasing firms the same tax treatment accorded publicly-traded firms. One approach already exists: the at-risk rules applicable to leasing by controlled groups under section 465. The rules there permit losses to be deducted if the companies in a group have a certain number of employees, performed at least five separate leasing transactions and had at least $1 million in gross receipts from equipment leasing. The at-risk rules would seem to satisfy any concerns about whether leasing is being conducted on an active basis.

The passive loss rules were designed to discourage tax-motivated transactions. In the case of leasing, the result has been to catch small businesses that are competing with large businesses through the same activities the larger firms pursue. The Internal Revenue Code should be amended to recognize that closely-held C companies are often engaged in active leasing businesses by removing the passive loss rules current bias against them.

STATEMENT OF THE AMERICAN FARM BUREAU FEDERATION
TO THE HOUSE WAYS AND MEANS SUBCOMMITTEE ON
SELECT REVENUE MEASURES
REGARDING H.R. 1411

June 24, 1993

The American Farm Bureau Federation, the nation's largest general farm organization representing over four million member families from every state and Puerto Rico, is pleased to support the enactment of H.R. 1411, a bill to amend the Internal Revenue Code of 1986 to double the maximum benefit under the special estate tax valuation rules for certain farm real estate property.

In our 1993 policy developed by the voting delegates at our 74th annual meeting held in Anaheim, California, in January, we state as follows:

> "We support elimination of the $750,000 ceiling allowed in determining the existing exemption under Internal Revenue Code 2032-A for agricultural productive value."

H.R. 1411 would move us substantially closer to our goal of eliminating the current statutory ceiling of $750,000 by doubling that amount to $1,500,000. This will allow prime agricultural land to remain in production and will help ease the inter-generational transfer of family-owned farms and ranches.

We feel this bill is definitely a step in the right direction, and it should be enacted promptly.

Thank you for the opportunity to file this statement.

Chairman RANGEL. Congresswoman Johnson had an opening statement, and by unanimous consent it will be entered into the record.

[The prepared statement and attachment follow:]

Statement by The Honorable Nancy L. Johnson on Legislation to Provide Relief from Retroactive Application of Gift Tax Regulation on Disclaimers

Mr. Chairman, I am here in support of legislation to correct a long-standing injustice which has resulted from the retroactive application of a federal gift tax regulation. The regulation involved was issued in 1958 and deals with the gift tax treatment of disclaimers.

As the Committee knows, the intended recipient of an inheritance or other gift may refuse to accept the interest in the property. Such a refusal is called a disclaimer, and under state law the property would then pass according to the wishes of the transferor as though the person making the disclaimer had died before the transfer was initiated. If the disclaimer is qualified for tax purposes, it is not treated as a taxable gift by the person making the disclaimer, and rightfully so, since the disclaimant has not accepted the property and has not designated where the property should go.

Under decisions of the federal courts before 1958, a disclaimer that was valid under state law did not result in a taxable gift, and the regulation issued by the IRS in 1958 did not appear to change this rule. Thus, in the case of a contingent future interest, a disclaimer made within a "reasonable time" after termination of the preceding interest was considered an effective disclaimer of the future interest. The IRS even issued a private letter ruling confirming this interpretation of the regulation. However, 14 years after the regulation was issued, in 1972, the IRS first publicly announced that it would give it a different interpretation, contending that a disclaimer of a pre-1958 contingent future interest would be free from gift tax only if made shortly after the initial transfer which created the contingent interest. The IRS position was rejected by a Federal Court of Appeals, but was ultimately upheld by the Supreme Court in 1982 (the Jewett case).

What all this means is that the government changed the rules in the middle of the game, and further, determined 24 years after the regulation was issued that the change should be given retroactive effect. This is grossly unfair to taxpayers, and the family of Connecticut resident and former constituent, Page Wodell, is one of those who has been so unjustly treated, with particularly harsh results.

In 1937, Page's grandfather died, leaving a will that established a trust with the income to be paid to Page's grandmother for life, and at her death the remainder was to go Page's mother and aunt, but only if they survived. Page's grandmother died in 1970, and Page's mother disclaimed her remainder interest four days later. The IRS claimed this disclaimer was not made in a "reasonable time" and thus was a taxable gift, and Page has sacrificed nearly everything he has, including selling his house, to pay this tax. (At the same time, Page's aunt disclaimed her interest under the same will; her case was decided by the Court of Appeals which held against the IRS, before the Supreme Court decided Jewett. As a result, Page's aunt's disclaimer escaped gift tax altogether.)

Now under the rule in effect before the 1958 regulation, Page's mother did not have to disclaim her contingent interest until some future date when her mother died and her contingent interest vested. But under the retroactive interpretation given the 1958 regulation by the Supreme Court, the day after the regulation became effective, it was 20 years too late for Page's mother to have disclaimed; she was required to have disclaimed her interest soon after it was created, back in 1937. Thus, the 1958 regulation changed the rules but never gave those who held contingent interests a grace period to make a tax-free disclaimer. And it is even more unfair because the IRS never said it viewed the regulation as a change in the rules until 14 years after the regulation was issued.

The Ways and Means Committee has consistently avoided such retroactivity when legislating changes in the tax law. Accordingly, my proposal would correct this injustice for the group which has been most unfairly treated by the IRS, those holders of pre-1958 interests who made disclaimers before May 22, 1972, when the IRS first told the public its position that the 1958 regulation changed prior law. The proposal would provide those disclaimants with the basic fairness they deserve, providing the grace period the IRS should have given in the 1958 regulation.

At this time I would like to submit for the record a detailed technical statement prepared by Page's counsel.

STATEMENT OF K. MARTIN WORTHY
BEFORE THE SUBCOMMITTEE ON SELECT REVENUE MEASURES
HOUSE COMMITTEE ON WAYS AND MEANS
JUNE 24, 1993

My name is K. Martin Worthy. I am a lawyer in the firm of Hopkins & Sutter in Washington, D.C. and have practiced tax law for more than 35 years. I was Chief Counsel for the IRS for three years and have been Chairman of the Tax Section of the American Bar Association.

I am presenting this statement in support of legislation which would correct a serious inequity which has resulted in the ***retroactive*** application of federal gift tax. The amendment relates to disclaimers of property interests originally created before 1958.

It has been accepted for over fifty years that a disclaimer or renunciation refusing to accept a gift or transfer by will is not itself a transfer subject to gift tax if the disclaimer is valid and properly made. Although until 1976 the Internal Revenue Code ("Code") contained no provisions governing the gift tax effect of disclaimers, in 1958 the Treasury published a Regulation recognizing this court-established principle. Section 2518 of the Code (the disclaimer provision first adopted in 1976) applies only to disclaimers of interests created after 1976, so that disclaimers of earlier interests, including all the interests covered by the proposed amendment, are governed solely by the 1958 Regulation and case law.

I represent the Estate of Mrs. Helen W. Halbach, who died while a resident of New Jersey in 1972. Mrs. Halbach's disclaimer is one that would be covered by the proposed amendment. I believe the following chronology of our case will demonstrate the unfairness of the situation both for Mrs. Halbach's estate specifically and generally, for other disclaimants who meet the requirements of the proposed legislation.

Mrs. Halbach's father died in 1937, and by his will established a trust with the income to be paid to Mrs. Halbach's mother for life, with the remainder to be divided later equally between Mrs. Halbach and her sister in the event of their survival of their mother. Thus, Mrs. Halbach's interest was wholly contingent and would not vest or become possessory in any sense until after her mother's death.

Mrs. Halbach's mother died on April 14, 1970, and Mrs. Halbach, four days later, executed a document in which she irrevocably renounced and disclaimed all her right, title and interest in the one-half share of the trust to which she would otherwise have been entitled. The bank administering the trust thereupon brought an action in the New Jersey courts to determine the effect of the disclaimer, and the Chancery court of New Jersey, in a carefully developed opinion (274 A.2d 614), held in late 1970 that the disclaimer, having been executed promptly after the death of the life tenant, was effective to prevent any passage of title to Mrs. Halbach. The Court thus required distribution of the half interest in the trust, to which Mrs. Halbach would otherwise have been entitled, just as if Mrs. Halbach had not survived. Significantly, the Court noted not only that this was the accepted law of New Jersey, but also that the Court had been unable to turn up any court decision anywhere that to be effective a remainderman's renunciation must occur (as the Internal Revenue Service would later contend) within a reasonable time after learning that a remainder interest had been ***created***. Thus, the Court concluded that it was sufficient if renunciation occurred within a reasonable time after ***termination*** of any preceding life interest.

As I will discuss, Mrs. Halbach had no reason to believe, when she executed her disclaimer in 1970, that she had in any way made a transfer of property subject to gift tax. However, by reason of the Supreme Court's 1982 decision in Jewett v. Commissioner and the failure of Congress in enacting section 2518 to deal specifically with disclaimers of interests created before 1976, Mrs. Halbach's estate is faced with a gift tax on the value of the trust interest which she disclaimed in 1970, just as if she had accepted it and then later voluntarily transferred it to persons of her own choosing.

Before the 1958 Regulation the U.S. Courts of Appeals had made it clear that a disclaimer which was valid and effective under state law did not result in a taxable gift. (These and other authorities are discussed more fully in the attached "Technical Analysis.") Although there was some variance in state disclaimer statutes and some states had no disclaimer statutes at all, it was clear from the authorities (such as Page on Wills) that as a general rule a disclaimer of an interest was valid under state law if it was unequivocal, made without prior acceptance, and made within a reasonable time. Furthermore -- just as later held by the New Jersey court in connection with Mrs. Halbach's disclaimer -- in the case of an interest which did not take effect in immediate possession, a disclaimer did not have to be made before the termination of the preceding interest to meet the "reasonable time" requirement.

In the Jewett case, however, the Supreme Court held that, under the 1958 Regulation, a disclaimer after 1958 of a pre-1976 interest (*i.e.*, one created before the effective date of section 2518 of the Code) will be recognized as free from gift tax only if the disclaimer is made shortly after the disclaimant obtains knowledge of the ***creation of such interest*** rather than after knowledge of ***its vesting***, as the courts had previously held. Under this interpretation future interests must have been disclaimed soon after their creation, no matter how unlikely or contingent the possibility that anything would ever be received. This interpretation of the 1958 Regulation is clearly contrary to accepted case law before 1958 (and contrary to what many justifiably understood the law still to be even after the Regulation was promulgated in 1958 and until well after Mrs. Halbach executed her disclaimer in 1970). Accordingly, application of the Supreme Court's decision to Mrs. Halbach and other holders of pre-1958 contingent interests is very unfair. Under existing case law before the Jewett decision in 1982, they had no reason to disclaim a pre-1958 contingent interest until after they obtained knowledge that the interest had vested, even if they had knowledge of the existence of the interest from its creation. Yet the 1958 Regulation, as interpreted by the Supreme Court in Jewett, gave such holders no opportunity to disclaim their pre-1958 interests without gift tax, since it ***was already too late to do so when the Regulation was promulgated.***

It should be emphasized that Mrs. Halbach had no reason to know at the time of her disclaimer in 1970 that the IRS would claim that such disclaimer was subject to gift tax. The Supreme Court acknowledged in its opinion in Jewett that it was not entirely clear even after 1958 whether the Regulation required that the disclaimer be made upon creation of a contingent remainder interest or upon subsequent vesting on death of the life tenant.

(1) In fact, the position taken by the IRS in the Jewett litigation with respect to the meaning of the 1958 Regulation is specifically inconsistent with the Service's interpretation of such Regulation in Private Letter Ruling 6612201590A, which was issued by the Service prior to Mrs. Halbach's disclaimer ***in 1970***. We have been unable to find why this ruling was not called to the Supreme Court's attention in Jewett, and the Court, in making its conclusion, mistakenly found that "the Commissioner's interpretation of the regulation has been consistent over the years" and concluded that it was therefore "entitled to respect."

(2) In truth, as acknowledged by counsel for the Commissioner of Internal Revenue in oral argument on December 1, 1981, it was not until litigation in the Tax Court in ***1972*** that the Service first publicly stated that it interpreted the Regulation as it now does, as requiring the holder of a future contingent interest to disclaim shortly after knowledge of its creation rather than after knowledge of the termination of the preceding interest.

(3) That the taxpayer knew or should have known that the Regulation meant what the Service now claims it means was certainly not obvious to the United States Court of Appeals for the Eighth Circuit as late as ***1973***, when it held that the interpretation now claimed by the Internal Revenue Service and the Treasury Department was incorrect. Keinath v. Commissioner, 480 F.2d 57. The Eighth Circuit reaffirmed this view in

1980 in Cottrell v. Commissioner, 628 F.2d 1127, holding that Mrs. Halbach's sister's disclaimer of her identical interest in the same trust at the same time was not subject to gift tax. Mrs. Halbach and other disclaimants were simply operating within the law in effect at the time of their disclaimers -- the law as interpreted in the Keinath and Cottrell cases.

The proposed amendment would correct the injustice of the Supreme Court decision in the Jewett case, for both estate and gift tax purposes, by providing that a disclaimer of a pre-1958 interest will be treated as satisfying all requirements of the Regulation if made before May 22, 1972 and within a reasonable time after the preceding interest terminates and the disclaimant's interest vests. The May 22, 1972 date is the date of the Tax Court's decision in Keinath, the case in which the Service first publicly stated its contention that, when the Regulation was issued in 1958, it was already too late to disclaim an existing contingent interest. Thus, the proposed amendment is limited to those who were treated most unfairly by the effect of the Jewett decision -- holders of such interests who disclaimed before the IRS first made its interpretation public in May 1972.

The amendment would allow a grace period of one year after enactment of the provision for making a refund claim with respect to each of the specified disclaimers, regardless of the statute of limitations or finality of any prior decision.

In the past the Treasury Department has opposed a similar legislative proposal because it was to be "retroactive." It is ironic that they put so much emphasis on retroactivity of the proposed legislation and do not express the same concern about the retroactivity of the Government's interpretation of the 1958 Regulation, first announced in 1972, saying that Mrs. Halbach, whose contingent remainder interest was created in 1937, should have ***made her disclaimer 21 years before the 1958 Regulation imposing the new test was issued.*** Surely, the *ex post facto* nature of this Regulation, retroactively changing the rules, without any grace period, as to when a pre-1958 contingent interest may be disclaimed without gift tax, cries out for Congressional redress.

Treasury has also opposed a similar amendment on the ground that the rule for disclaimer of post-1975 interests under section 2518 is consistent with the Jewett interpretation of the 1958 Regulation for pre-1976 interests, that timeliness for both is gauged from the time the interest is created. However, the legislative history of the 1976 Act (which adopted section 2518) indicates to the contrary that Congress believed that the Court of Appeals in the Keinath case stated the proper interpretation of the rule for pre-1976 interests. *See*, H. Rept. 94-1380, 66, 1976-3 C.B. 800.

Most recently, Treasury has suggested that the Supreme Court is scheduled to decide this issue in Irvine v. United States. This is not so. At issue in the Irvine case is a different portion of the 1958 regulation. It would be entirely possible for the Court to affirm the taxpayer's Court of Appeals victory in Irvine without reversing Jewett. Conversely, enactment of the proposed legislation would not affect the result in Irvine.

In conclusion, it is our contention that it is only fair and equitable for this Congress to provide relief to taxpayers who in good faith relied on existing case law and never had an opportunity to make a timely disclaimer of their pre-1958 contingent interests, as the Supreme Court has interpreted the requirements of the 1958 Regulation.

Congressional relief from the imposition of the Federal gift tax on the disclaimer of pre-1958 interests is particularly appealing in the instant case under a "basic fairness" test, since my client made the identical disclaimer at the same time as her sister who has been relieved from such gift tax by the Eighth Circuit.

TECHNICAL ANALYSIS AND BACKGROUND CONCERNING PROPOSAL ON THE TAX TREATMENT OF DISCLAIMERS OF CERTAIN REMAINDER INTERESTS

I. BACKGROUND

As noted above, although until 1976 the Internal Revenue Code of 1954 ("the Code") contained no provisions governing the gift tax effect of disclaimers, in 1958 the Treasury published a Regulation recognizing this court-established principle. However, even under the Regulation, the effectiveness of a disclaimer for federal tax purposes varied according to applicable state law. By the 1970's it had become apparent to members of the tax bar and others that a uniform definition of disclaimers would be desirable for federal tax purposes. See, H. Rept. No. 94-1380, 66, 1976-3 C.B. 735, 800.

In response to the movement for a uniform disclaimer rule, Congress enacted new section 2518 of the Code in the Tax Reform Act of 1976. That section generally requires that a "qualified disclaimer" for federal estate and gift tax purposes, i.e., a disclaimer that does net constitute a taxable gift, be made (a) in writing, (b) before acceptance of the interest being disclaimed or any of its benefits, and (c) within 9 months after the later of the date on which the transfer creating the interest is made or the day on which the disclaimant attains age 21. Section 2518 was subsequently amended in 1978 and 1981 to perfect and clarify the uniform rule.

Under present law section 2518 applies only to disclaimers of interests created after December 31, 1976. Thus, the broad class of disclaimants of interests in trusts created before 1958 remains subject to the law in effect before section 2518 was enacted, irrespective of when the interests become possessory and when the disclaimers are made -- even 40 or 50 or more years from now.

II. REASONS FOR PROPOSED AMENDMENT

In Jewett v. Commissioner, 102 S. Ct. 1082 (1982), the Supreme Court of the United States, interpreting section 25.2511-1(c), Gift Tax Regs., held that a disclaimer after 1958 of an interest created before 1977 will be recognized as free from federal gift tax only if it is made shortly after the initial transfer from which the interest sought to be disclaimed eventually emerged. Under this interpretation, future interests must have been disclaimed soon after their creation, no matter how unlikely or contingent the possibility that anything would ever be received. Such an approach is contrary to the view, widely held before the Supreme Court decided Jewett, that the 1958 Regulation permits a tax-free disclaimer within a reasonable time after the death of the preceding life tenant, i.e. after the disclaimed interest becomes present and possessory. Moreover, as interpreted by the Supreme Court, the Regulation represents a sharp departure from the law in effect prior to 1958 under which the effect of such a disclaimer was generally governed solely by State law. Thus, the application of the Supreme Court's decision to holders of interests created before 1958 is very unfair; they had no reason to disclaim before that time and never had an opportunity to disclaim without gift tax -- even "within a reasonable time" -- after the Regulation was promulgated.

Law Before 1958

Prior to the 1958 Regulation there were few cases involving the federal estate and gift tax effect of disclaimers. Nevertheless those few cases made clear that disclaimers which were valid and effective under state law did not result in a taxable gift.

In 1933, the Sixth Circuit decided Brown v. Routzahn, 63 F.2d 914, cert. den. 290 U.S. 641 (1933). In Brown decedent's wife died in 1912 and left decedent one-third of all her property. An April 1920, before any distribution was made, decedent filed with the proper probate court a renunciation of his right to the third of the estate, and the court, ordering distribution to the remaining heirs, recognized the renunciation. However, at decedent's death the Commissioner contended that the value of the

renounced property should be included in decedent's estate for federal estate tax purposes as a transfer made in contemplation of death.

In analyzing the issue, the Court of Appeals began from the "obvious" premise that unless the decedent accepted the gift of one-third of his wife's estate or became owner of such interest before April 1920, there could be no transfer of such interest in contemplation of death within the meaning of the tax statute. The court looked to state law and found that under Ohio law a rejection of a gift by will made any time before distribution would be valid and that decedent therefore had never become owner of the property involved. Accordingly, the court concluded that his renunciation of the property could not be a taxable transfer for federal tax purposes.

There was no indication by the Internal Revenue Service of its intent not to follow the Brown decision. No other decision bearing significantly upon the issue arose until 1952, when the Eighth Circuit decided Hardenbergh v. Commissioner, 198 F.2d 63, cert. den. 344 U.S. 836 (1952). In Hardenbergh the taxpayers attempted to renounce their interest in the estate of a decedent who had died intestate, and the Internal Revenue Service claimed that the disclaimer constituted a taxable gift. The Eighth Circuit found that immediately upon the death of the decedent title to the disclaimants' interests had vested in them by operation of Minnesota law which neither disclaimant had the power to prevent, with the result that their subsequent disclaimers constituted transfers of such interests for federal gift tax purposes. Thus Hardenbergh reinforced the principle that validity of a disclaimer under state law controlled for federal estate and gift tax purposes. Indeed, Hardenbergh cited Brown with approval with respect to disclaimers of testamentary gifts, carefully distinguishing Brown on the basis of the testate/intestate law difference. 198 F.2d at 66.

A number of commentators during this period recognized the principle that state law controlled in determining the tax effect of disclaimers. *See, e.g.*, Ekman, "Can A Transferee Avoid Gift or Estate Tax Liability by Renouncing A 'Transfer By Operation of Law,'" 11 N.Y.U. Inst. on Fed. Tax'n 527, 532-534 (1953); Sayles, "Renunciations -- Estate and Gift Tax Problems," 1953 S. Cal. Tax Inst. 531, 536-539. There was some variance in state disclaimer statutes, and some states, in fact, had no disclaimer statute at all. Nevertheless, as a general rule a disclaimer of an interest was valid under state law if it was unequivocal, made without previous acceptance, and made within a reasonable time. 6 Bowe-Parker, Page on Wills § 49.9, 49.1, 49.8 (1962); 96 C.J.S. § 1151(b), 1151(a) (1957). In the case of an interest which did not take effect in immediate possession, a disclaimer did not have to be made before the termination of the preceding interest to meet the "reasonable time" requirement. See 6 Bowe-Parker, Page on Wills § 49.8 (1962). *Also see*, Estate of Page, 74 A.2d 614, 615-616 (N.J. Super. 1970).

A review of these cases and commentary reveals that prior to 1958 nothing in federal estate or gift tax law would require the holder of a remainder interest created by will to disclaim immediately upon the creation of the interest. Generally under state law the holder could wait until a reasonable time after the termination of the preceding interest, and the decided cases indicated that federal tax consequences of the disclaimer were controlled by state law. Against this historical background, section 25.2511-1(c), Gift Tax Regs., was issued in final form on November 15, 1958.

The 1958 Regulation

Section 25.2511-1(c), Gift Tax Regs., which has not been changed since it was promulgated in final form in 1958, provides in pertinent part as follows:

> "***Where the law governing the administration of the decedent's estate gives a beneficiary, heir, or next-of-kin a right to completely and unqualifiedly refuse to accept ownership of property transferred from a decedent*** (whether the transfer is effected by the decedent's will or by the law of descent and distribution of intestate property), ***a refusal to accept ownership does not constitute the making of a gift if the refusal is made within a reasonable time after knowledge of the existence of the transfer. The refusal must be unequivocable*** [sic] ***and effective under the local law. There can***

be no refusal of ownership of property after its acceptance. Where the local law does not permit such a refusal, any disposition by the beneficiary, heir or next-of-kin whereby ownership is transferred gratuitously to another constitutes the making of a gift by the beneficiary, heir or next-of-kin. In any case where a refusal is purported to relate to only a part of the property, the determination of whether or not there has been a complete and unqualified refusal to accept ownership will depend on all of the facts and circumstances in each particular case, taking into account the recognition and effectiveness of such a purported refusal under the local law. In the absence of facts to the contrary, if a person fails to refuse to accept a transfer to him of ownership of a decedent's property within a reasonable time after learning of the existence of the transfer, he will be presumed to have accepted the property. In illustration, if Blackacre was devised to A under the decedent's will (which also provided that all lapsed legacies and devises shall go to B, the residuary beneficiary), and under the local law A could refuse to accept ownership in which case title would be considered as never having passed to A, A's refusal to accept Blackacre within a reasonable time of learning of the devise will not constitute the making of a gift by A to B. However, if a decedent who owned Greenacre died intestate with C and D as his only heirs, and under local law the heir of an intestate cannot by refusal to accept, prevent himself from becoming an owner of intestate property, any gratuitous disposition by C (by whatever term it is known) whereby he gives up his ownership of a portion of Greenacre and D acquires the whole thereof constitutes the making of a gift by C to D." Emphasis added.

This version of the Regulation is somewhat different from a draft initially proposed on January 3, 1957, which required a renunciation to be made "within a reasonable time after knowledge of the existence of the ***interest***" (emphasis added), rather than after knowledge of the existence of the "***transfer,***" as provided in the final Regulation. The word "interest" would clearly include a contingent remainder even though the creation of that remainder by will did not effect a "transfer" to the disclaimant. Thus, under the Regulation as originally proposed, the holder of a future interest would only have had a reasonable time after the creation of the interest in which to disclaim and would not have been permitted to wait until the interest became present and possessory by transfer of the property to him.

On its face, this difference between the proposed and final regulations suggests that the final Regulation was a rejection of the requirement of the proposed regulation that a disclaimer of a contingent interest be made within a reasonable time after its creation rather than a reasonable time after it became possessory. However, in its Jewett opinion the Supreme Court considered the change in language and concluded, based on a Memorandum from the Commissioner of Internal Revenue to the Secretary of the Treasury, dated October 1, 1958, that the reason for the change was unrelated to the issue of when a future interest must be disclaimed. With respect to the disclaimer Regulation, the Memorandum provides in part as follows:

> "In what was intended to be the application of the rules in Brown v. Routzahn (1933) 63 F.2d 914, cert. denied 290 U.S. 641, and Hardenbergh v. Commissioner (1952) 198 F.2d 63, cert. denied 344 U.S. 836, it was stated that where title to the property did not vest in the beneficiary or heir immediately upon the decedent's death, the renunciation of the property did not constitute the making of a gift, but that, where title vested in the beneficiary or heir immediately upon the decedent's death, the act of the beneficiary or heir in giving up what passed to him from the decedent constituted the making of a gift. . . . Protests on these provisions were received. After reviewing these protests, we have reconsidered our position and now believe that the proper distinction between these two court cases turns on the question of whether under the applicable State law a beneficiary of heir can or cannot refuse to accept ownership of the property which passed from the decedent. Accordingly, we have revised paragraph (c) of section 25.2511-1 to reflect this change of position." XIII Tax Notes 203, July 27, 1981.

Two things are apparent: (1) Even if it is assumed that the drafters of the final Regulation were not intentionally trying to state a different rule for contingent interests than set forth in the proposed regulation, this would not have been apparent to holders of contingent interests at the time, since the Memorandum was not made public until June 15, 1981. (2) The Memorandum clearly indicates that the drafters were trying to soften the inflexibility of the proposed rules and to provide, instead, that state law would apply in every situation. And, as previously noted, under the law applicable in most states, in the case of an interest which did not take effect in immediate possession, a disclaimer did not have to be made before the termination of the preceding interest to meet the "reasonable time" requirement.

It was not immediately apparent that the 1958 Regulation was intended to make a change in the Treasury position as to when a valid disclaimer must occur. Although it specified three requirements not mentioned in Brown – that a disclaimer be unequivocal, that it be made before acceptance of the interest, and that it be made within a reasonable time of knowledge of the existence of the transfer, the Eighth Circuit subsequently observed that the conditions in the Regulation were "but a codification of common law principles applicable to the doctrine of disclaimers." Keinath v. Commissioner, 480 F.2d 57, 61 (1973).

What taxpayers and the tax bar did not then know was that the IRS would eventually introduce a new concept by contending that when it said a taxpayer must disclaim within a reasonable time after "the transfer," it meant in the case of a contingent interest, a reasonable time after creation of the interest rather than a reasonable time after the interest became possessory. It was in litigation of Keinath v. Commissioner in the Tax Court in 1972, that the Service first publicly took the position that the Regulation required the holder of a future interest to disclaim shortly after the interest was created rather than after the termination of the preceding interest. *See* statement of counsel for the Commissioner of Internal Revenue in oral argument before the U.S. Supreme Court in Jewett v. Commissioner, No. 80-1614, 44-45 (December 1, 1981). This position of the Service was inconsistent with the Brown case, which the Memorandum indicates was intended to be embodied in the Regulation, and contrary to the general principle of state law that disclaimers could be made after termination of the preceding life interest.

It now further appears that the position the IRS took in Keinath was also inconsistent with its own position in an earlier private letter ruling (6612201590A) dated December 20, 1966. (Although private rulings were confidential at that time, since 1976 they have been released to the public, and this particular ruling was made open to public inspection on August 28, 1978.) In that ruling the IRS held that a taxpayer's proposed disclaimer of a contingent interest in a trust created 33 years earlier would not be taxable as a gift. The taxpayer had a present possessory interest in a portion of the trust from its creation, and on the death of other life tenants without "issue" the taxpayer became eligible for additional fractional income interests. The Service ruled that if the taxpayer executed a disclaimer "within a 'reasonable time' from the time that she first received notice [by reason of a court decision that the income interest had vested in her] of her right to the additional income interest," the requirements of the Regulation would be satisfied and no gift tax would be due. Because the taxpayer already held another interest in the trust from which she had received income for nearly 30 years, she had obviously long been aware of the creation of the trust 33 years earlier and of her contingent interests in the additional shares in the event of survivorship. Thus, the above quoted language of the ruling means that she had a reasonable period from the time she received notice that her additional contingent income interest had vested or become possessory, even though that interest had been created 33 years earlier.

Although this private letter ruling was public when the Jewett case was briefed and argued before the Supreme Court, the Court was apparently not made aware of the inconsistent interpretation of the Regulation made by the IRS. In fact, the Court expressly noted in upholding the Commissioner's interpretation of the Regulation that

the Service had been consistent in its interpretations over the years (102 S.Ct. 1090) -- which is simply not so.[1]

Conclusion

This examination of the federal gift tax law on disclaimers before and after 1958 demonstrates that under the Brown and Hardenbergh cases the validity of the disclaimer under state law determined the federal gift tax result. Thus, before 1958 the holder of a contingent remainder had no reason to disclaim prior to the death of the preceding life tenant.

After the promulgation of the 1958 Regulation it was not apparent that there had been any change in the law. First of all, the deletion of language from the proposed regulation which required disclaimer "within a reasonable time after knowledge of the existence of the ***interest***" suggested that a disclaimer could be delayed until indefeasible vesting. Furthermore, the October 1, 1958, Memorandum from the Commissioner to the Secretary of the Treasury shows that the drafters of the Regulation were trying to follow the existing law of the Brown and Hardenbergh cases. In addition, the IRS itself, in Private Ruling 6612201590A, issued December 20, 1966, ruled that a disclaimer of a contingent future interest would satisfy the Regulation if made after notice that the interest had vested and become possessory. Indeed, it was not until litigation of the Keinath case in the Tax Court in 1972, after Mrs. Halbach's 1970 disclaimer, that the IRS first publicly took the position that a defeasible future interest must be disclaimed shortly after its creation.

Despite these indications of the meaning of the Regulation, the Supreme Court in Jewett adopted the Commissioner's current contrary interpretation.[2] Thus, under the Supreme Court's interpretation, the IRS, by promulgating the 1958 Regulation, changed the rules for a taxpayer owning an interest created before 1958 in the middle of the game, contrary to any reasonable notion of justice or fair play.

In rejecting a similar unfairness argument by the taxpayer in Jewett, the Court noted that the 1958 Regulation was made well in advance of the disclaimers in that case.[3] However, what is important here is that the interests to which the proposed legislation would apply were created before 1958, not that it was disclaimed after 1958. The Regulation did not provide a grace period for disclaimers after it was promulgated, and as Jewett reads the Regulation, at that point it was already too late. Thus, holders of pre-1958 interests were unfairly and unjustifiably prevented from ever disclaiming without incurring a gift tax. Congress recognized this very transition problem when it made the rules of section 2518 applicable only to disclaimers of interests created after 1976. *See*, section 2009(e) of the Tax Reform Act of 1976, P.L. 94-455, 90 Stat. 1520.

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[1]Even though section 6110(j) (3) of the Code provides that private rulings ordinarily "may not be used or cited as precedent," the Supreme Court -- in refusing to accept the government's interpretation of a long-standing regulation in Rowan Companies, Inc. v. United States, 101 S. Ct. 2288, 2296, n. 17 (1981) -- has said that private rulings may be cited as evidence that the Internal Revenue Service has taken a position inconsistent with its present contentions as to the meaning of the law and regulations.

[2]One commentator has criticized the Court's construction of the Regulation as "visibly flawed." Jewett v. Commissioner: Unforseen Crisis of Disclaimers, 14 Loy. L. Rev. 167, 186 (1982). *See also*, M. Wolfson, "Disclaimers -- A Device Whose Time Has Come?," 41 N.Y.U. Inst. on Fed. Tax'n 43-1, 43-23 to 43-27 (1983).

[3]The Court made the puzzling comment that the taxpayer's argument would have more appeal if the disclaimer had been made immediately after the adoption of the 1958 Regulation, rather than 14 years later. 102 S.Ct. 1090, n. 20. The logic of this statement is difficult to understand if, in fact, the Regulation required disclaimer in 1939 when the disclaimed interest was created.

The proposed amendment would correct the unfair effect of Jewett on holders of pre-1958 future interests by providing that their disclaimers will be treated as meeting all requirements of the Regulation if made before May 22, 1972 and within a reasonable time of vesting of the interest. As the discussion above shows, the equities weigh heavily in favor of such relief.

PROPOSED STATUTORY LANGUAGE

SEC. _____ Transitional Rule for Pre-May 22, 1972* Disclaimers of Property Interests Created by Gifts, Devises or Bequests Made before Promulgation of Regulations on November 15, 1958.

With respect to an interest in property created by a gift, devise, or bequest made before November 15, 1958, a disclaimer by a person of such interest (in whole or in part) shall not be treated as a transfer for purposes of chapters 11 and 12 of subtitle B of the Internal Revenue Code and shall be deemed to satisfy all the requirements set forth in Treasury Regulation Section 25.2511-1(c) as in effect at the time the disclaimer was made, if such disclaimer was made in writing before May 22, 1972, and no later than a reasonable time after the termination of all interests in such property prior to the disclaimed interest. This section shall apply notwithstanding any law or rule of law (including but not limited to section 7481 of the Internal Revenue Code of 1986 as amended) concerning the finality of court decisions or other determinations, barring multiple suits on one cause of action, or limiting the time when a claim or suit for refund of tax may be brought, provided that the benefit of this section is claimed within one year of the date of enactment of this Act.

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* This is the date the Tax Court decided Keinath v. Commissioner, 58 T.C. 352, in which the Internal Revenue Service for the first time publicly took the position that the 1958 Regulation required a disclaimer of a contingent interest to be made shortly after creation of the interest, rather than vesting.]

Chairman RANGEL. It is the chairman's desire to keep the panel moving during this vote, and so at this time I yield to Mr. Hoagland.

Mr. HOAGLAND [presiding]. Mr. Jacobs, do you have any questions?

Mr. Thompson, do you have a statement to make?

Mr. THOMPSON. I am here as a technical reference.

Mr. HOAGLAND. You are here as a shotgun.

Mr. EGE. To answer any technical tax questions that may come up.

Mr. HOAGLAND. Mr. Reynolds.

Mr. REYNOLDS. Thank you, Mr. Chairman.

I would like to ask a quick question to Mr. Knox.

Mr. Knox, it seems that the Treasury wants to support the passive foreign investment company protection for the securities business, but not for the financing business. From my quick overview of this particular problem, it doesn't seem to make sense to me. Can you elaborate on that as to why you think that they are not seeing this the way some of us believe they ought to see it?

Mr. KNOX. I think they would concede that, substantively, foreign finance companies are more deserving of protection than securities companies. Their problem, they say, is the difficulty—there are so many financial service companies. The problem is defining what is truly a financial service company and what is not. That is what they say is their problem.

I might add that the law already exempts banks. And the problem is that there are lots of different kinds of banks. In fact, if one were fair about it, financial service companies are banks in every sense of the word except they do not take in deposits. You cannot walk in off the street and make a deposit. Other than that, they are banks. So I believe that if they would simply look at the services being performed, they would conclude that banks and financial service companies are identical and that they would not have any trouble with phony financial service companies.

These are regulated companies. They are regulated in many instances by the same governmental authority that regulates banks. I think it would be a very simple matter if they would apply themselves to it.

Mr. REYNOLDS. It seems to me that in the past they have been willing to do the work to make the distinction when they have had regulations like, for example, with the Continental Bank in Chicago, which is a bank and is governed by all the regulations, even though you can't deposit money, you can't go there to get a loan, but it meets all the standards of a bank. And they have made the distinction and looked at it as an individual case.

Mr. KNOX. Congressman Reynolds, you are exactly right. If the Continental Bank were incorporated in a foreign country instead of the United States, it would be subject to the PFIC rules, which shows how ridiculous this is.

Mr. REYNOLDS. Thank you, Mr. Chairman.

Mr. HOAGLAND. Mr. Jacobs, any questions?

Mr. JACOBS. No.

Mr. HOAGLAND. Mr. Fink, I notice here from the testimony presented by Les Samuels on Tuesday, I think, that Treasury says,

with respect to your proposal, quote, do not oppose in part, close quote. Now, have you seen their writeup here?

Mr. FINK. I assume I have the same writeup. It is labeled number 2.

Yes, I gather they don't oppose about 90 percent of the proposal. And I think that where it is a passthrough of portfolio interest, interest that under the U.S. Tax Code is not withheld against when received by foreigners, the Treasury does not oppose that portion of a fund's dividends being exempt from withholding when paid out.

Their objection, I believe, is to a smaller portion that is not coming from portfolio interest, which would be such things as repo interest, interest on bearer bonds, et cetera. And their concern is that they would like to bargain that change by treaty rather than, as I understand it, with Tax Code changes.

But I think it misses the point of Mr. Gibbons bill because today when a foreign investor living in France or the United Kingdom or Germany or Japan receives nonportfolio interest income directly, we do not withhold against him. This bill simply would say if a mutual fund earned nonportfolio interest income and paid dividends to the foreigner, it would not be withheld against.

So while I want to support U.S. treaty negotiations, I think if you want to make U.S. mutual funds fully competitive overseas—and Mr. Ege's problem right now is that foreigners won't invest in U.S. mutual funds—if you want to do that fully, nonportfolio interest income should be included as well as portfolio income.

But I guess the first point is, that the Treasury is 90 or 95 percent in agreement with the Gibbons bill, and it is only on nonportfolio interest income where the problem exists.

Mr. EGE. That is my understanding as well. I am getting a clarification from Treasury—I am sure the committee and the staff can as well—that if interest is otherwise taxable if received directly, and is subject to withholding, this bill does not change that or otherwise make it not subject to withholding by virtue of the bill.

We certainly agree with that. It is the converse we are concerned about, that gains which would not be subject to withholding if the funds are invested directly become subject to withholding tax merely because they are invested via a pooled portfolio. All of us who invest in mutual funds understand the reason is for diversification, and it should not be treated differently for tax purposes when it is pooled. I think that is the principal concern of those of us in the mutual fund industry, and we share Treasury's concern on that point.

Mr. HOAGLAND. Let me ask the two of you this. If this committee were to adopt your proposal to the extent the Treasury does not oppose it, would that be worth the effort? Would that be helpful?

Mr. FINK. Well, it is a large part of the loaf, but I am not ready here today to compromise it, with all due respect.

I think I would rather sit and talk to Treasury because I think their objection is misplaced. They have already negotiated treaties with other countries to say that when a foreigner receives nonportfolio in interest income directly, he doesn't get withheld against. They simply haven't done it for nonportfolio interest income received through mutual funds.

I don't see the problem in making the change through the Internal Revenue Code rather than by treaty. I think we would have to sit down with Treasury and, depending on those discussions, see what we could agree on. Like everybody else, we would rather have three-quarters of a loaf than nothing, but I don't think the part they object to is all that bad.

Mr. HOAGLAND. I would——

Mr. FINK. Mr. Ege would kill me if I compromised. He is in the business.

Mr. EGE. The critical issue here is the short-term capital gains passthrough as well as the interest passthrough. Current law makes it almost impossible to sell a U.S. equity fund to a foreign investor, institutional or otherwise, when what is otherwise short-term capital gain is turned into dividend income and has a 30 percent withholding tax against it.

Mr. HOAGLAND. I would certainly encourage the two of you to try to work out something with Treasury. When Treasury comes in opposing something as they have in Miss Stodghill's and Mr. Knox's proposal, it certainly makes it an uphill fight.

What we will do is temporarily recess this hearing until Chairman Rangel returns from voting. We have only about 5 minutes left on the vote so I think I better get over there. When Chairman Rangel returns, why, we will begin panel two.

[Recess].

Chairman RANGEL [presiding]. The chair will resume its hearing and ask for panel two to come forward: Peter McCloskey, president of Electronic Industries; Michael Farren, Xerox Corp.; General James Abrahamson, chairman of the board of Oracle Corp.—and I have just left Congressman Tom Lantos who wanted to share his apologies at not being able to introduce you, but he is chairing another meeting in another part of the building—and Steve Keating, vice president of taxes for Computer Associates out of New York.

We will start with President McCloskey.

STATEMENT OF PETER F. McCLOSKEY, PRESIDENT, ELECTRONIC INDUSTRIES ASSOCIATION

Mr. MCCLOSKEY. Thank you, Mr. Chairman.

I am Pete McCloskey, president of the EIA. I am pleased to present the views of the U.S. electronics industry as well as associate myself with the views of my copanelists from Xerox, Oracle, and IBM.

I am going to talk specifically about the 50 percent limitation up on foreign trade income pertaining to the military sales of foreign sales corporation (FSCs).

As you know, Mr. Chairman, U.S. manufacturers who establish a foreign sales corporation are granted a lower effective income tax rate on profits from export sales. Exporters of military products, however, have only been eligible for one-half of the tax rate reduction that is provided for commercial products. We believe this differential treatment is both extremely unfair and unwise, and we urge its immediate change.

It is EIA's view that we are consistent with both U.S. foreign policy and U.S. arms export control laws, foreign military sales should be an important part of our industrial base strategy. These sales

help to sustain the domestic production and employment base, bolster our national balance of trade, promote broader economic goals and help meet our foreign policy objectives.

The concern of foreign military sales should be monitored by means other than tax policy, and certainly should not be a reason to continue a tax policy that in effect limits the enormous benefits that we gain from selling and coordinating our defense capabilities. Ultimately, our allies have alternate sources for their legitimate defense requirements and will go elsewhere for military equipment denied them by the United States.

Equally important, the U.S. Government retains control over arms exports under the Arms Export Control Act which assures that a full review of the proposed sale takes place. The intense international competition and the need for leverage in a competitive environment begins once the United States is convinced that the sale is consistent with existing U.S. policy.

In addition, EIA believes it is imperative as a matter of national security that the United States maintain technological leadership in defense technology and invest in the next generation of leading edge weapons systems. Given that it will be almost a decade before many of these systems can be delivered in quantity, it is vital for policymakers to look to export sales as a way of maintaining employment for thousands of skilled defense workers and hundreds of defense subcontractors.

Moreover, export sales can help hold down costs of future systems acquisition and provide the United States with warm production lines should an unexpected contingency arise.

In the global economy of the 1990s, companies for many nations are now intense competitors with American companies in every area of commerce, including the development and manufacture of the most sophisticated systems of national defense, strategic and tactical communications, and arms and munitions of every description.

There are virtually no areas where sales of military products can be made by American companies free of competition from foreign manufacturers, many of whom are heavily subsidized by their governments. Moreover, foreign buyers of military property often exert significant pressure on U.S. manufacturers to locate their manufacturing facilities in the buyer's country.

It is our view that there is no valid economic reason to continue a tax policy that discriminates against exports of U.S.-made defense products at a time when U.S. defense contractors are facing intense competition from abroad.

The fundamental unfairness of the rule for military property contained in section 923(a)(5) of the IRS Code which reduces by half the portion of export income from the sale of military property that could be considered tax exempt is such that the provision should be repealed.

Thank you, Mr. Chairman.

Chairman RANGEL. Thank you.

[The prepared statement follows:]

ELECTRONIC INDUSTRIES ASSOCIATION

STATEMENT OF

PETER F. MCCLOSKEY
President

ELECTRONIC INDUSTRIES ASSOCIATION

Concerning Miscellaneous Revenue Provisions

Before The
Committee on Ways & Means
Subcommittee on Select Revenue Measures

Thursday, June 24, 1993

I INTRODUCTION AND EXECUTIVE SUMMARY

Good morning Mr. Chairman. My name is Peter McCloskey and I am President of the Electronic Industries Association. I am pleased to present the views of the U.S. electronics industry to the Subcommittee this morning on the repeal of the 50% limitation upon foreign trade income pertaining to the military sales of foreign sales corporations (FSCs). In addition, we are also pleased to offer general comments on the proposal to reduce the depreciation period for semiconductor manufacturing equipment from 5 to 3 years, the proposal to provide for the use of 200-percent declining balance depreciation for computers for alternative minimum tax purposes, the proposal to permit companies to allocate all deductions for tax payments made to states to U.S.-source income, and the proposal to extend the period to which excess foreign tax credits may be carried forward from 5 to 15 years.

EIA is uniquely positioned to discuss the broad range of tax policy issues affecting our industry's international competitiveness. As the industry's oldest full service association, EIA is a vigorous trade organization with a close connection to a membership which represents the entire spectrum of the U.S. electronics industry from the smallest niche manufacturers to the largest international corporations. Our members comprise the most dynamic, growing, and forward-looking sector of the U.S. economy, and because of the nature of the electronics field, we have our finger on the pulse of the leading manufacturing and export segments within industrial America -- all key facets in understanding the current trends and future prospects for U.S. competitiveness.

II PRESERVING THE U.S. INDUSTRIAL BASE -- ARGUMENTS FOR THE REPEAL OF SECTION 923(a)(5)

Since 1985, U.S. manufacturers who establish a Foreign Sales Corporation (FSC) have been granted a lower effective income tax rate on profits from export sales. Exporters of military products, however, have only been eligible for one-half the tax rate reduction that is provided for commercial products. This restriction on tax benefits for exports of military products is a carryover from a 1976 amendment to the tax code dealing with Domestic International Sales Corporations, the predecessor of the FSC. The restriction represented a compromise between the views of some lawmakers that sales of military products did not warrant a tax incentive because they were not sold in a competitive marketplace, and those who believed a tax incentive was warranted whenever the sale was competitive with foreign-manufactured goods.

Where consistent with U.S. foreign policy, international military sales have been and continue to be an important element of our industrial base strategy. These sales help to sustain the domestic production and employment base, bolster our national balance of trade, promote

broader economic goals, and help meet our national foreign policy objectives. In addition, EIA believes it is imperative -- as a matter of national security -- that the U.S. maintain technological leadership in defense technology and invest in the next generation of leading-edge weapon systems. Given that it will be almost a decade before many of these systems can be delivered in quantity, it is vital for policymakers to look to export sales as a way of maintaining employment for thousands of skilled defense workers and hundreds of defense subcontractors. Moreover, export sales can help hold down costs of future systems acquisition and provide the U.S. with warm production lines should unexpected events occur.

In the global economy of the 1990s, companies from many nations are now intense competitors with American companies in every area of commerce, including the development and manufacture of the most sophisticated systems of national defense, strategic and tactical communications, and arms and munitions of every description. There are virtually no areas where sales of military products can be made by American companies free of competition from foreign manufacturers, many of whom are heavily subsidized by their governments. Moreover, foreign buyers of military property often exert significant pressure on U.S. manufacturers to locate their manufacturing facilities in the buyer's country.

The concerns of foreign military sales should be monitored by means other than tax policy, and certainly should not be a reason to continue a tax policy that in effect limits the enormous benefits that we gain form selling and coordinating our defense capabilities. Ultimately, our allies have alternative sources for their legitimate defense requirements and will go elsewhere for military equipment denied them by the United States.

As a result, EIA believes that there are compelling reasons for the U.S. to encourage the export of U.S.-made defense products to friendly nations around the globe. An aggressive program in this regard will serve U.S. strategic interests and help sustain the U.S. defense industrial base at a time of declining defense spending. Whatever merit was attached to the original 1976 restriction on tax benefits for sales of military products has been obviated by the intense competition associated with the post-Cold War global defense marketplace. The U.S. defense industry will be tested in the years ahead due to significant contraction of its business base resulting from the end of the Cold War, and due to increasing international competition for sales abroad.

It is our view that there is no valid economic reason to continue a tax policy that discriminates against exports of U.S.-made defense products at a time when U.S. defense contractors are facing intense competition from abroad. The special rule for military property contained in section 923(a)(5) of the Internal Revenue Code, which reduces by half the portion of export income from the sale of military property that can be considered tax exempt, should be repealed.

III THE SPEED OF CHANGE AS THE COMPETITIVE DIFFERENCE -- ARGUMENTS FOR ENHANCED COST RECOVERY

EIA's support for both the proposed reduction in the depreciation life of semiconductor manufacturing equipment as well as for the use of 200-percent declining balance depreciation for computers (for alternative minimum tax purposes) reflects the fact that the rate of change in technology has both a technical and an economic basis in fact. As more and more product markets become "commodity" type markets with smaller and smaller profit margins attached to them, manufacturers increasingly search for new opportunities that provide the potential for greater than average returns. Global competition, however, assures that no market which yields high margins will remain without competition for long. Soon after a firm establishes a profitable new niche, competitors come racing into it and provide cost-conscious customers with alternative products or services. This, in turn, eventually changes the high-margin, niche market into a lower-profit, commodity-type market with aggressive price competition.

As a result of this continuous chain of events, our industry finds a tremendous need to constantly reduce product development and introduction cycle time. This concept, also called "fast response" or "time-to-market," underscores the fact that the faster a leading-edge technology can be brought to market, the more economically valuable it becomes to the firm or firms involved in its development. Not surprisingly, however, while the rapidity of change associated with first-to-

market pressures often positions the firm to expand both earnings potential and employment, it also frequently serves to obsolete underlying production equipment and/or processes as technology improves with new market applications.

The spiraling effects of this process are obvious: (1) change can only be expected to accelerate in the technology marketplace of the next century, (2) speed has become -- and will continue to be -- a competitive advantage at both the macro and micro levels of the economy, and (3) public policy must be cognizant of the implications that stem from the rapid rate of change in high technology markets. As a result, the economic concept of useful life -- upon which depreciation class lives have been historically based -- must constantly be updated to reflect the fact that the speed to market pressures of today's global economy place unending downward pressure upon realistic useful lives for high technology manufacturing equipment.

There is another benefit that time to market pressures have created and it is reflected in the total quality management movement. The U.S. Department of Commerce, which is the agency that awards the prestigious Malcolm Baldrige National Quality Award, notes in its annual examination questionnaire that:

> "[S]uccess in competitive markets increasingly demand[s] ever shorter product and service introduction cycles and more rapid response to customers * * * improvements [in product and service cycle time] are often accompanied by simultaneous improvements in [product and service] quality. Hence it is highly beneficial to consider response time and quality together."

The relationship between speed and quality has become increasingly clear over the past decade and one-half. The need to rapidly respond to market opportunities means that firms must identify and execute only upon value-added steps. The economic value of time becomes exceedingly important under such circumstances and can only be maximized when economic conditions adequately and accurately reflect the impact of diminishing product cycle time upon production equipment useful life. As a result, more generous cost recovery proposals -- including the proposal to reduce the depreciation period for semiconductor manufacturing equipment from 5 to 3 years and the proposal to provide for the use of 200-percent declining balance depreciation for computers for alternative minimum tax purposes -- make increasing economic sense.

IV PROPOSAL TO PERMIT COMPANIES TO ALLOCATE ALL DEDUCTIONS FOR TAX PAYMENTS MADE TO STATES TO U.S.-SOURCE INCOME

Over the past 15 years, the Internal Revenue Service has, in general, advanced a regulatory policy which requires an increasingly extensive allocation of state taxes paid by corporations to foreign source income. Regulations issues in 1991 reinforced this view. This policy has the effect of lowering the amount of foreign source income against which the foreign tax credit can be applied and, therefore, lowers the amount of foreign tax credit available to offset U.S. taxes.

The net effect of denying a full deduction for state income taxes is to saddle U.S. corporations with an additional tax cost of doing business. This is particularly troublesome for those U.S. companies which compete with foreign corporations in the domestic American market since foreign firms operating in the United States are usually able to obtain a full credit deduction for state taxes.

Unfortunately, this policy appears consistent with other efforts by the Internal Revenue Service to require the allocation of more and more domestic business expenses (e.g., research and development expenses under Section 861-8) to foreign source income and, as such, represents an increasingly anticompetitive policy to high technology firms operating in world markets. As noted toward the end of this testimony, EIA believes that federal policymakers must enact domestic economic policies which help make the United States the world's best place in which to manufacture. The growing trend toward allocation of domestic expenses and state taxes to foreign source income runs wholly opposite to creating an optimal domestic, manufacturing-based employment environment.

Indeed, in an era of corporate downsizing and tremendous pressures upon corporate cost structures occasioned by brutal price competition on a global basis, it is clear that when government increases fixed costs -- either directly through the tax code or indirectly through various social mandates -- companies must respond by lowering variable costs. The two most directly controllable variable costs, unfortunately, are levels of employment and wage rates. To the extent that foreign source allocation regulations ignore the realities of the global market, they narrow the ultimate base of taxpayers and thus frustrate the Service's primary goal of enhancing the domestic revenue base.

Finally, we agree with Senator David Boren's 1990 floor statement concerned legislation he introduced in the 101st Congress to address this problem.[1] In it, he noted not only the competitiveness arguments discussed above, but other problems associated with the issue, including:

> "The IRS position inequitably subjects U.S. multinationals to inconsistent taxing regimes. States, which are constitutionally prohibited from taxing income attributable to foreign activities, believe they are taxing income attributable to in-State activities. The U.S. Supreme Court has affirmed this belief in the face of taxpayer challenge to States taxes. This IRS position, however, is that States are taxing foreign source income. U.S. multinationals are caught in the middle. They are subject to state tax on the grounds the tax is not on foreign source income. This inconsistent treatment is unjustified and needs to be resolved."

V PROPOSAL TO EXTEND THE PERIOD TO WHICH EXCESS FOREIGN TAX CREDITS MAY BE CARRIED FORWARD FROM 5 TO 15 YEARS

Consistent with the comments concerning the allocation of state tax payments, EIA is concerned with the competitiveness impact of an unrealistically short foreign tax credit carryfoward. The primary purpose of the foreign tax credit is to prevent or relieve the instance of double taxation. Any incidence of double taxation would obviously create a direct negative impact upon cash flow and earnings and, as such, limit the ability of U.S. companies to compete in both foreign and domestic markets with international competitors unaffected by such provisions. If the U.S. views the worldwide income of U.S. taxpayers as appropriate for taxation, then recognition of the need for and policy appropriateness of an effective and meaningful foreign tax credit is obvious.

Indeed, we agree with the 1989 report of the Ad Hoc Tax Electronics Group that:

> "From a pure policy perspective, the carryforward provision for a foreign tax credit should be unlimited sense there is no logical time limit to the need for relief which a taxpayer would experience, absent the credit. However, carryforward provisions similar to other Internal Revenue Code provisions would be acceptable for the sake of administrative simplicity."

In other words, the issue of an unlimited foreign tax credit carryforward is underscored by the fact that the foreign tax credit is different than many other important incentive-type credits in the code. The foreign tax credit seeks to alleviate the unfairness associated with double taxation and, as such, should not be forfeited simply due to the expiration of an arbitrary statutory time limitation. Nevertheless, the legitimate need for consistency within the code is such that EIA would support a standardization of the foreign tax credit carryforward consistent with current code standards for other existing credits.

VI THE ROLE OF THE ELECTRONICS INDUSTRY IN OVERALL U.S. COMPETITIVENESS

The electronics industry plays a central role in the overall health of the U.S. economy in today's global economy. In 1992, U.S. sales of electronics products -- registering about $285 billion -- continued to demonstrate the dynamism which led to a compound annual growth rate of 7.7% over the past decade. In terms of employment, electronics directly employs some 2 million Americans and is larger than steel, automotive and oil & gas combined.

Indeed, electronics has led the way in bringing our nation's economy fully into the global marketplace. A number of our largest member companies are well-known and successful global companies who derive more than half of their total revenues from export sales. Included in this group are such industry leaders as Intel, Motorola, Boeing and AMP Incorporated. These figures help underscore the fast-paced nature of the U.S. electronics industry as well as the benefits and challenges for the U.S. economy stemming from globalization and international competition.

We are pleased to note that our industry has been making strong recent progress. For example, U.S. electronics exports exceeded $71.6 billion in 1991, a 7% increase over 1990. In addition, the U.S. is poised to expand its already strong position in key high technology markets of the future. Among the most promising are U.S. advances in such technologies as flash memory and digital signal processing.[2] In addition, we are greatly encouraged by America's recent reemergence as the leader in the world semiconductor market.[3]

During the past few years, the U.S. electronics industry has maintained a competitive position relative to its overseas rivals. For example, Electronic Business magazine reported the following at the end of 1991[4]:

	Net Income (% of sales)	Return on Equity	Return on Investment	R&D as % of Sales	Capital Expenditures as % of sales
Asia	3.2%	10.3%	5.6%	3.3%	7.4%
Europe	2.0%	7.7%	4.3%	5.4%	6.0%
North America	5.0%	12.8%	5.9%	5.5%	7.7%

We reject the claims of American decline in high technology but caution that both the recent macro-level and individual product-level achievements of the U.S. high technology sector are by no means guaranteed and that the pressures associated with international competition will remain intense for the domestic economy.

On the macro level, for example, although U.S. R&D spending continues to lead the world, Japan and Germany spend about the same fraction of their GNP on R&D and a much larger share of their GNP on non-defense and/or commercial R&D. Moreover, corporate R&D funding in Japan and Germany has likewise grown faster over the past decade in these two nations than in the United States, although it still has not reached U.S. levels in electronics.

All of this means that positioning the U.S. economy for a leading role in the global marketplace of the next century will require continued private and public sector efforts directed toward enhancing overall national competitiveness. The Subcommittee's role in this regard cannot be overstated.

For example, while we believe that government support of judicious measures aimed at cutting-edge technologies with broad application to multiple industries can clearly be beneficial, we also believe that such efforts will not alone suffice to advance national competitiveness. The essential domestic challenge for government is the formulation of policies that will encourage firms to take the individual private actions required to strengthen American international competitiveness through improving the rate of productivity and the pace of investment throughout the economy. Specifically and by way of example, all of the provisions we comment on today qualify in this regard.

For individual companies, the challenge is one of continued emphasis upon product and process quality, total customer satisfaction, application-specific product orientation, increasingly shorter times to market, and employee empowerment. For federal policymakers, the challenge entails a thorough readjustment of how government relates to industry.

Sustained U.S. success in the international economy over the next several decades means that, in broad strategic terms, federal policymakers must:

- enact domestic economic policies which help make the United States the world's best place in which to manufacture,[5]

- continue efforts to open markets abroad, and
- avoid restrictions upon globalization by manufacturers who look to add high-value/high-wage content through processes and activities occurring within the U.S.

We agree with President Clinton that "the United States must * * * ensure that its tax, trade, regulatory and procurement policies encourage private sector investment and innovation" and we look forward to working with the Subcommittee in securing the enactment of policies consistent with this important goal.

Indeed, as technological prowess becomes increasingly perceived as a symbol of our nation's competitive strength, interest in policies to promote U.S. success in high technology trade competitiveness has mounted. This interest has remained keen not only because of the anticipated employment and trade effects that export-based electronics manufacturing will continue to produce, but also because of the anticipated technological spillover effects on other U.S. industrial sectors as well.[6]

By way of example, we believe that one of the most critical sectors of the electronics industry is microelectronics.[7] Semiconductors are at the center of electronics products and are a major source of innovation in products and processes throughout the economy. The spillover effects that the broader electronics industry has on the economy as a whole are underscored by the linkage impacts (i.e., sustained economic benefits in linked activities) that arise in sectors such as microelectronics when semiconductor chip production generates a cycle in which increased investment in research & development and capacity leads to increasing chip performance at decreasing cost. The improved price-performance characteristics in turn deliver improved price-performance in downstream products like computers, and also generate new markets in new product areas such as anti-skid braking systems.

As these markets expand downstream, a substantially increased demand for chips is generated. Increased user demand occasions expanding investment in chip development and production which leads to another round of improved price-performance breakthroughs. The cycle (including its enhanced effects on U.S. employment and trade balances) is repeated. Such has been the history of the microelectronics industry for over three decades.

Moreover, advances in chip technology depend upon and contribute to continued technological innovation in physics, chemistry and materials sciences. For example, it is no coincidence that the advances of the past several years in superconducting materials originated partly at IBM Research, AT&T Bell Laboratories and Bellcore where the search for superfast microelectronic switching devices for computer and telecommunications applications motivated experimentation with superconductivity. The gains from superconductivity will not be confined to chips or to the larger electronics industry, but will pervasively influence activities ranging from electricity generation to high-speed transportation – again, underscoring the benefits flowing from the electronics sector to the rest of U.S. industry as well as the need for national policies which support its continued growth.

VII CONCLUSION.

Thank you, Mr. Chairman, for the opportunity to present our views. I would be pleased to answer any questions.

NOTES

1. See: Statement of Senator David L. Boren (D-OK), 101st Congress, Cong. Rec., May 7, 1990 at S5768.

2. See: Gene Bylinsky, "A U.S. Comeback In Electronics", Fortune, April 20, 1992 at 77.

3. See: T.R. Reid, "U.S. Again Leads in Computer Chips", Washington Post, November 20, 1992 at A1.

4. For purposes of comparison and understanding, North America was home to 43 of the top 100 international electronics firms surveyed in the study. Of these 43 firms, the article notes that 42 are U.S. firms and 1 is Canadian. See: Linda Stallmann, "The Electronic Business 100", Electronic Business, November 4, 1991 at 58-59.

5. In The Competitive Advantage of Nations, Harvard economist Michael E. Porter argues, inter alia, that the competitive infrastructure created by industrial "clustering" is one of the penultimate advantages for a nation to develop and maintain. "Going against the conventional wisdom that global markets, computer networks and modern communications have obliterated the importance of geography in business, Porter says the evidence is that eye-to-eye contact is more important than ever. The clustering effect, he contends, "leads to an entire system. Local universities take notice, specialized programs are created, institutes grow up, specialized infrastructure happens, local suppliers get interested in investing."" To this end, Porter has argued that the federal government "can help mainly by promoting the conditions in which clusters flourish. He supports trade liberalization efforts by Washington and policies, such as capital gains tax incentives, that he believes encourage investment in growth industries. He also favors policies that ensure vigorous domestic competition, as well as federal funding of roads and airports, and highly specialized apprenticeships and training programs with the potential for benefiting particular local industrial clusters." See: Dan Morgan, "Think Locally, Win Globally", Washington Post, April 5, 1992. See also: Michael E. Porter, The Competitive Advantage of Nations, (New York, NY: The Free Press, 1990).

6. The electronics industry is tightly linked to many other portions of the U.S. economy. Not only do the nation's defense industries depend upon electronic technologies but both manufacturing and service industries -- ranging from the production of numerically controlled machine tools to banking and insurance -- use electronic products both directly and indirectly.

These products -- which range from CB radios to satellite-based communications systems, carbon resistors to vastly powerful computers -- are probably distributed more widely through the rest of the U.S. economy than the output of any other industry. Because many electronics products serve as inputs into other sectors of the economy and because they are produced under conditions of increasing returns or declining costs due to the significant learning curve economies realized in their production, the electronics sector gives rise to what economists call "linkage externalities" -- increasing private returns in the electronics industry are accompanied by increasing societal returns in downstream user industries [see discussion infra].

7. To this end, the EIA Board of Governors established a new Multi-Chip Module (MCM) Division in 1992 to deal with the broad new concepts of electronic assembly and packaging. This Division will cover new technologies for raw materials, design manufacturing, test and application. The Division will have the widest scope of any within EIA and will be a model for future cooperative industrial, scientific, governmental, and academic growth. For further background on MCM, see also: Bernard Levine, "Multichip Modules Spark Systems Debate", Electronic News, November 16, 1992, pp 1,12.

Chairman RANGEL. Mr. Farren.

STATEMENT OF J. MICHAEL FARREN, VICE PRESIDENT OF EXTERNAL AFFAIRS, XEROX CORP.

Mr. FARREN. Thank you, Mr. Chairman and members of the subcommittee. I am pleased to present testimony on behalf of Xerox Corp. regarding H.R. 1401, legislation that would remove certain barriers imposed upon U.S. businesses operating in European Community member countries.

I am joined this morning by Mr. Russ Okasako, who is vice president of taxes for Xerox Corp.

We believe that the EC, the world's largest integrated market, offers enormous opportunities for U.S. businesses to expand their global operations. For U.S. businesses to have an equal opportunity to compete with other foreign companies in the EC, however, U.S. tax and international trade laws must be reconciled with the emerging new laws and economies of the EC.

Xerox Corp. markets its products in every State and in over 100 countries. Corporate headquarters are located in Connecticut, and its products are manufactured principally in New York, California and Oklahoma. Xerox also operates major research and development facilities in New York and California.

Xerox and its affiliates have made a significant investment of resources and capital in the EC member countries as a marketing vehicle for products manufactured in the United States.

In the existing environment, Xerox must deal with each of the 12 member countries of the EC individually through separate subsidiaries. Now that trade barriers between EC countries are being lifted, however, maintenance of this cumbersome corporate structure no longer makes economic sense.

Responding effectively to the new environment requires restructuring of Xerox's EC operations to operate through a single subsidiary responsible for all aspects of Xerox business in the EC member countries. Operating costs would be reduced significantly through the centralization of such functions as warehousing, accounting, purchasing, cash and currency management, sales and services and inventory management.

However, this essential restructuring to meet our legitimate business needs has been delayed due to the current U.S. tax laws which would effectively penalize the centralized operating subsidiary handling all business in separate EC countries.

The Tax Code's, subpart F, sales and service income rules, present U.S. multinationals with a paradoxical incentive to maintain duplicative subsidiaries in each EC country in which they do business. These rules impose immediate U.S. taxation—so-called subpart F penalty—on a foreign subsidiary's income on certain transactions involving, as an example, a product manufactured in the United States and sold through its foreign subsidiary to a consumer in a third country.

U.S. corporations are confronted with a choice between maintaining inefficient and complex corporate structures in each of the EC countries or losing U.S. tax deferral on their EC source income. In contrast, the European and Japanese companies, against which U.S. multinationals must compete, are able to make sound busi-

ness decisions and reshape their corporate structures to respond to the new single market without such artificial tax barriers.

The impact of the foreign tax rules for U.S. multinationals operating in the EC can best be described by analogy to the United States. If similar rules were in effect in the United States, each U.S. corporation would be encouraged to establish a self-contained subsidiary in each State and would have to file and maintain the appropriate records and documents required by individual States.

Each subsidiary would be constrained from selling products for consumption or use outside of its State of incorporation, and parent companies would lose a substantial portion of the cost efficiencies associated with centralized management and operations.

Under this analogy, U.S. companies would be governed by these rules while foreign companies could operate far more efficiently as a single corporation throughout the United States.

U.S. multinationals are at just such a disadvantage in the EC, as they are effectively denied by their own government the opportunity available to their foreign competitors to consolidate their European operations to take advantage of the development of the single market.

Imagine the outrage if it was the EC that imposed such a regime on U.S. multinationals. It would certainly ignite a significant trade controversy.

H.R. 1401 is the product of 3 years of discussion. We believe that it would serve to resolve the problems that we are now confronting.

In some instances, the Tax Code is intentionally designed to affect business behavior in a way considered to be supportive of national economic or social goals. We think 1401 would give us an opportunity to achieve the social goals of increasing U.S. exports overseas and more effectively competing in the EC market.

Chairman RANGEL. Thank you.

[The prepared statement follows:]

STATEMENT OF J. MICHAEL FARREN,
VICE PRESIDENT, EXTERNAL AFFAIRS, XEROX CORP.

Introduction

Mr. Chairman and members of the Ways and Means Subcommittee on Select Revenue Measures, I am pleased to present testimony on behalf of Xerox Corporation regarding H.R. 1401. This legislation would modify the current subpart F rules of the Internal Revenue Code to remove certain barriers imposed upon U.S. businesses operating in the European Community ("EC") member countries. We believe that the EC, the world's largest integrated market, offers enormous opportunities for U.S. businesses to expand their global operations. For U.S. businesses to have an equal opportunity to compete with other foreign companies in the EC, however, the U.S. tax and international trade laws must be reconciled with the emerging new laws and economics of the EC. The enactment of H.R. 1401 would greatly enhance our ability to compete with our foreign competitors in the EC.

We appreciate the opportunity to appear at these hearings and hope that we can provide some insights into some of the problems that confront U.S. multinational corporations attempting to take advantage more fully of the opportunities being created in the EC.

Background

Xerox Corporation ("Xerox") markets its products in every state and in over 100 countries. Its corporate headquarters are located in Connecticut, and its products are manufactured principally in New York, California, and Oklahoma. Xerox also operates major research and development facilities in New York and California.

The largest segments of the Xerox business are the development and manufacture of document processing products and the services related to such products which are designed to make offices around the world more productive. This business includes production of copiers, duplicators, electronic printers, electronic typewriters, software as well as the servicing and supplies related to these products.

Xerox maintains majority ownership, control or management, either directly or indirectly, of virtually all of its more than 100 subsidiaries. These subsidiaries perform sales, distribution, manufacturing and service functions primarily in Europe, the Far East, Canada, Central and South America and the Caribbean. Xerox's operations in these countries are essential to the absorption of base costs, including research and development investments, incurred in the United States and to reducing its unit cost of production, thereby better enabling its products to be competitive in both the United States and in foreign markets.

As we are all aware, the United States has continued over recent years to be burdened with enormous trade deficits, notwithstanding the increased attention focused on this issue by Congress, the Administration and the business community. In this context, the development of the EC single market presents U.S. multinational corporations with a unique opportunity to develop and expand their markets in the EC's twelve member countries and also provides companies greater access to the emerging markets in Eastern Europe.

Xerox and its affiliates have made a significant investment of resources and capital in the EC member countries as a marketing vehicle for products manufactured in the United States. In the existing environment, Xerox must deal with each of the twelve member countries of the EC individually through separate subsidiaries. Xerox currently maintains a separate marketing corporation in each EC member country and operates four separate manufacturing centers, including distribution outlets for manufactured and imported products, within the EC. These separate local companies were formed prior to the enactment of subpart F to develop the markets in the separate EC countries. Now that these markets have been developed and trade barriers between the EC countries lifted, however, the maintenance of this cumbersome corporate structure no longer makes economic sense. The paradox is that U.S. tax laws effectively require that U.S. multinationals continue to maintain this cumbersome corporate structure.

Since the mid-1980s, Xerox has been attempting to "rationalize" its European corporate structure and business operations in response to the development of the EC Single Market. To do so, it is necessary to consolidate its twelve distinct marketing subsidiaries as well as its four separate manufacturing and distribution subsidiaries. The goal of this restructuring will be to operate eventually through a single subsidiary responsible for all aspects of Xerox's business in the EC member countries. Operating costs will be reduced significantly through the centralization of such functions as warehousing, accounting, purchasing, cash and currency management, sales and services and inventory management. Centralized warehousing and distribution centers will be established to reflect the new EC economic structure and to respond to the geographic and regional operational requirements within the EC rather than the artificial political boundaries of the separate member countries. Thus, Xerox will be able to compete more effectively in the EC market. This essential restructuring to meet our legitimate business needs has been unnecessarily delayed due to the current U.S. tax laws, specifically, subpart F, which would effectively penalize a centralized operating subsidiary handling all business in the separate EC countries.

Operating in Europe through separate subsidiaries performing duplicative functions is both costly and unnecessary. Our Japanese and European competitors have already begun to consolidate their activities in the EC to take advantage of the unified market and are obtaining a distinct advantage over U.S. companies in efficiency and operating costs. In contrast, U.S. companies have been forced to maintain their inefficient operating structures or face current U.S. taxation of the earnings of European subsidiaries, regardless of whether those earnings are repatriated or are reinvested in European operations. It is imperative that the U.S. government respond to these disincentives by removing the current barriers of the tax code that prevent the rationalization of these European operations. Particularly, the definitions of foreign base company sales and services income found in sections 954(d) and (e) of the Code should be amended to eliminate these obstacles to the restructuring of European operations.

Current Law Treatment of Subpart F Income

Generally, a U.S. corporation is not taxed on the earnings of its foreign subsidiaries until those earnings are distributed to the U.S. parent corporation. The tax code, however, establishes an exception to that general rule by requiring the U.S. parent corporation of a foreign subsidiary to include in gross income its share of the "subpart F income" earned by the foreign subsidiary even though the income has not yet been distributed to the parent corporation.

One type of such subpart F income taxed currently in the U.S. is foreign base company sales income. In general, foreign base company sales income includes income earned by a foreign subsidiary in a transaction in which (i) a purchase or sale of a product is made between a U.S.-controlled foreign subsidiary and a related party, (ii) the product is manufactured outside the subsidiary's country of incorporation, and (iii) the product is sold for use outside the subsidiary's country of incorporation. Under these rules, income earned by our U.K. subsidiary on the purchase of a product manufactured in our Webster, New York plant and sold by the U.K. company to a customer in France would be tainted subpart F income, and the income on the transaction would be taxable in the United States even though the income is not distributed to Xerox corporation. If the U.K. company sold the same product to a customer in the U.K., rather than one in a third country, however, the income from the transaction would not be taxable as subpart F income in the United States. The foreign base company services rules operate in a manner similar to the foreign base company sales rules. Therefore, by establishing a separate subsidiary in each EC country in which it does business, rather than establishing a single consolidated subsidiary, a U.S. multinational can defer the tax on income received from similar transactions. The formation and maintenance of such separate subsidiaries, however, results in duplicative selling, technical and general and administrative expenses. Nevertheless, the foreign base company rules operate to encourage these inefficient operations.

Section 954(b) (4) of the Internal Revenue Code of 1954 provided an exception to current taxation under subpart F. Under this exception, a U.S. parent corporation could avoid current U.S. taxation under subpart F on the income earned by its foreign subsidiary if it could demonstrate that the avoidance of U.S. tax was not a significant reason for the creation of the foreign subsidiary or for the completion of the transaction giving rise to the income. The Tax Reform Act of 1986, however, eliminated this subjective exception, and the tax code now provides a similar exception (the "high-tax exception") only in cases where the foreign base company income has been subject to an effective rate of foreign tax greater than 90 percent of the maximum U.S. corporate tax rate. Although the maximum statutory tax rate in virtually every EC country is higher than the current maximum U.S. corporate rate, it is very difficult for a U.S. multinational to predict with any degree of certainty whether it will qualify for the high-tax exception from year to year. The differences between the tax rules and accounting methods applicable in foreign countries and the special rules applicable for purposes of calculating the effective foreign tax rate for subpart F purposes often can result in a foreign subsidiary not qualifying for this exception in any given year. Due to the resulting unpredictability as to whether income will be taxable as subpart F income or will qualify for the high-tax exception, many U.S. multinationals have opted for establishing separate subsidiaries in each of the twelve EC countries allowing them to avoid subpart F treatment of their foreign base company income.

The subpart F rules were enacted over thirty years ago to address Congress' concern over U.S. companies' creation of foreign base companies in tax haven jurisdictions. The primary basis for the new rules was the loss of tax revenue resulting from the artificial shifting of income by U.S. corporations to foreign subsidiaries created in tax haven jurisdictions merely to obtain lower tax rates. It is widely accepted that the EC countries do not qualify as "tax havens." Further, in enacting these rules, Congress did not intend to impair the competitive position of foreign subsidiaries established to conduct legitimate income producing activities.

Effect of Subpart F on U.S. Competitiveness in the Single Market

The definitions of foreign base company sales income and foreign base company services income present U.S. multinationals with a paradoxical incentive to maintain duplicative subsidiaries in each EC country in which they do business. U.S. corporations are confronted with the choice between maintaining inefficient and complex corporate structures in the EC or losing U.S. tax deferral on their EC-source income. In contrast, the European and Japanese companies against which U.S. multinationals must compete are able to make sound business decisions and reshape their corporate structures to respond to the new Single Market without such an artificial tax incentive to develop or continue costly operations in each EC country. If U.S. multinationals continue to be forced to maintain separate subsidiaries in each member country of the EC to avoid subpart F treatment of income, they will not benefit to the same extent as their foreign competitors from the dynamic of the EC single market.

The impact of the treatment of subpart F income for U.S. multinationals operating in the EC can best be described by analogy to the United States. If rules similar to subpart F were in effect in the United States, each U.S. corporation would be encouraged to establish a self-contained subsidiary in each state and would have to file and maintain the appropriate records and documents required by the individual states. Each subsidiary would be constrained from selling products for consumption or use outside of its state of incorporation, and parent companies would lose a substantial portion of the cost efficiencies associated with centralized management and operations. Under this analogy, U.S. companies would be governed by these rules while foreign companies could operate far more efficiently as a single corporation throughout the United States. These foreign corporations would have significant advantages over their U.S. counterparts. U.S. multinationals, however, are effectively denied the opportunity available to their foreign competitors to consolidate their European operations to take advantage of the development of the single market.

The definitions of foreign base company sales income and foreign base company services income enacted over 30 years ago were based on the premise that each country should be treated as a distinct market and that a company's country of incorporation is its natural business location. The primary purpose and goals of the EC single market, however, are contrary to this rationale. As a result, these definitions are outdated and counterproductive. Thus, the current subpart F rules must be amended to recognize the development of the EC and to permit U.S. companies to take advantage of the resulting business opportunities.

Treatment of the EC as a Single Country for Subpart F Purposes

Prior Legislative Proposals

In January 1990, the Committee on Ways and Means held hearings to discuss, among other issues, the implications of the developing EC market on direct U.S. investment in Europe. At that time, Xerox, along with other organizations, testified to the need for reform of the subpart F rules to eliminate the barriers to competing in the EC that are discussed above. In February 1990, in response to those calls for reform, Congressman Sam Gibbons (along with nine other Ways and Means Committee Members) introduced H.R. 4136, which would have amended the tax code to treat the twelve EC member countries as one country for purposes of the foreign base company sales and services income rules.

In response to certain technical concerns raised by the Treasury Department regarding H.R. 4136, in May 1991 Congressman Gibbons (along with nine other Ways and Means Committee Members) introduced a modified legislative proposal, H.R. 2277, also designed to level the playing field for U.S. companies operating in the EC. H.R. 2277 would have alleviated one of the U.S. tax barriers to competing in the EC by lowering from 90 percent to 80 percent the subpart F high-tax exception for controlled foreign subsidiaries operating in the EC. (Companion legislation, S. 1653, was introduced in the Senate by Senator Daniel P. Moynihan.) While we supported this legislation as a helpful "first step" toward rationalizing our EC operations, this proposal, if enacted, still would have left intact many of the uncertainties that exist under the current high-tax exception and still would have made it difficult for U.S. companies to predict whether a single corporation could meet the high-tax exception with respect to EC-sourced income. Moreover, under this proposal, U.S. companies would still be forced to track individual sales among the various EC countries and to maintain elaborate accounting records -- records generally not otherwise required to be kept -- to permit them to determine qualification for the high-tax exception.

Current Legislative Proposal

It has become increasingly clear that the general approach of H.R. 4136 of the 101st Congress is the simplest and most effective approach to removing the tax code's current barriers to efficient operations in the EC. To allow U.S. multinationals a fair opportunity to contend with their foreign competitors and to make sound business decisions regarding the streamlining of activities in the EC, subpart F should be amended to treat the EC as one country for purposes of the foreign base company sales and services income rules. This modification would permit U.S. multinationals to create more efficient European corporate subsidiary structures without risking the loss of tax deferral on income that has not been repatriated. As a result, this modification would enhance U.S. companies' competitive position in the European market and provide them with the same structural options that our European and Japanese competitors currently enjoy.

In March of this year, Congressman Gibbons introduced H.R. 1401 to treat the member countries of the EC as a single country for purposes of the foreign base company

sales and services rules. H.R. 1401 is identical to H.R. 4136, with the exception of one modification to strengthen the antiabuse provisions of that prior legislation. H.R. 1401 recognizes what is generally accepted to be the case -- that the EC member countries are not tax havens in which U.S. companies can form subsidiaries to shelter income from U.S. taxation. Importantly, however, this legislation contains sufficient antiabuse provisions to prevent U.S. companies from avoiding U.S. taxation on income that, due to special circumstances, may be sheltered from foreign taxation. Specifically, the one-country rule would not apply to EC countries that impose a maximum statutory tax rate less than 90 percent of the maximum U.S. corporate tax rate. Furthermore, the one-country rule would not apply in the case of countries that provide tax holidays, preferential statutory tax rates or similar special rules to effectively permit U.S.-controlled foreign corporations to avoid foreign taxation on their earnings. The Treasury Department would be provided with broad regulatory authority to prevent any potential abuses. This proposal has received growing support from other U.S. companies and trade associations as the opportunities in the E.C. become more evident.

Under the current foreign base company sales and services income rules, U.S. companies have been forced to establish otherwise unnecessary subsidiaries in each EC country to obtain the benefit of deferral from U.S. taxation of the earnings from their European operations. Consequently, the current rules likely have resulted in a relatively minor source of U.S. tax revenues. Since many U.S. companies likely will otherwise continue to maintain separate subsidiaries in each EC country if the subpart F rules are not modified (and will thereby continue to receive the income deferral), an amendment treating the EC as a single country should cause only a minimal reduction in U.S. tax revenues. This amendment, however, would allow U.S. multinationals to make the rational business decisions regarding their EC subsidiaries that are essential to remaining competitive in the developing EC market.

Summary

To take full advantage of the benefits offered by the unified EC market, U.S. multinationals must be able to consolidate their EC-country operations and eliminate current inefficiencies. The U.S. tax laws must be modified now where appropriate to provide U.S. corporations an opportunity to successfully compete with their foreign-owned competitors. European and Japanese businesses have already begun to implement the necessary corporate structural changes that will allow them to operate more efficiently in the EC market. Our current European corporate structure thus makes little economic sense in today's environment.

The current definitions of foreign base company sales and services income present an unnecessary obstacle to U.S. corporate planning and management in the EC. No important policy objective is served by subjecting to current U.S. tax the income of U.S.-controlled EC-country corporations from sales to and services rendered to customers located in other EC countries. This treatment is not consistent with subpart F's original policy goal -- to prevent the use of tax haven subsidiaries to avoid current U.S. taxation -- that led to the enactment of these rules.

H.R. 1401 will permit U.S. businesses to develop and expand their roles in the developing EC market. Accordingly, we strongly support H.R. 1401 and urge Congress to approve this legislation thereby allowing U.S. companies to make the rational economic decisions that will enable them to compete in the EC.

Chairman RANGEL. General Abrahamson.

STATEMENT OF GEN. JAMES A. ABRAHAMSON, CHAIRMAN OF THE BOARD, ORACLE CORP., REDWOOD SHORES, CALIF., ON BEHALF OF FSC SOFTWARE COALITION

General ABRAHAMSON. Thank you, sir. Mr. Chairman, I am James Abrahamson. I am the chairman of the board of Oracle Corp., and accompanying me today is Steve Keating, who is vice president of tax for Computer Associates.

Oracle is the third largest computer software company in the world. We are headquartered in California. Computer Associates, headquartered in New York, is the second largest computer software company.

Oracle and Computer Associates are members of a coalition that also includes Autodesk, Borland, Cadence, Comshare, Lotus, Novell, Sybase, WordPerfect, the American Electronics Association, which includes more than 600 software companies in its membership, and the Information Technology Association of America, which includes approximately 500 software companies in its membership.

The coalition that we represent includes both small and large companies in a business that in this information age is an industry that is most vital to America's future. Our industry's growth is dependent on our ability to export, and that growth in exports has resulted in increasing software development jobs in the United States.

The FSC Software Coalition supports a legislative proposal that would make clear that exports of software are not denied the foreign sales corporation benefits that are available to other exports. Specifically, the coalition supports a proposal to amend the FSC rules to make clear that exports of software qualify for FSC benefits even when they are accompanied by a right to reproduce that software overseas.

Congress enacted the FSC rules in order to assist U.S. exporters to overcome some of the advantages that foreign governments grant to their corporations through more beneficial tax systems and to encourage the growth of U.S. exports. Clearly, Congress wanted to help the Nation's balance of payments and keep high-paying jobs in the United States.

However, under a current IRS interpretation of these rules, many exporters of U.S. software are denied the benefits of the FSC provisions. The foreign sales corporation legislation allows FSC benefits to films, tapes, records or similar reproductions.

However, the Treasury has issued temporary regulations that grant FSC benefits only to the entertainment industry for the export of master recording tapes that are reproduced overseas. And they have issued specific regulations which deny the FSC benefits for computer software that is exported along with the right to reproduce that software overseas.

The computer software industry exports its products in a manner that is very similar to that of the entertainment industry. Thus, we think this is an issue of fairness.

To differentiate the treatment given to the entertainment industry and the computer software industry is not justifiable on tax pol-

icy grounds. Fairness and consistency would indicate that the same tax treatment for exports should be accorded to the entertainment and the computer software industries, and, frankly, we need the same FSC benefits as many others in order to remain competitive.

The Treasury temporary regulations ignore the fundamental way in which the computer software industry does its business and exports its products. Computer software companies regularly license a master tape of the software to an overseas distributor, or often to an original equipment manufacturer or to a company called a value-added reseller. These companies then make reproductions for end users.

The foreign distributors often must translate the software and the explanatory manuals—that indicate how the software works—from English into the local language, or make other minor revisions to comply with local law before the product is reproduced for the end user.

OEMs, the original equipment manufacturers, sell computers to end users with the software already installed. The OEM will often license a master tape of the computer software so that it can install copies of the software as they sell more computers. The value-added resellers may sell reproduced software directly or they may combine it with their own software for sale to the end user. This is true whether the ultimate user is in the United States or overseas.

These transactions are a normal part of our computer software business. These exports are valid and important exports to the U.S. economy, and they should not be denied the principal benefit that U.S. tax law grants to exporters.

The funds obtained by computer software manufacturers from their exports are available for additional investment in the research and development activities which, in most of our companies are still located in the United States. The additional research activities in the United States result in more high-paying jobs being created in this country.

We would like Congress to enact a clarification of the FSC rules which would make clear that the export of software which is accompanied by the right to reproduce that software is also eligible for FSC benefits.

Thank you, Mr. Chairman.

Chairman RANGEL. Thank you, General.

[The prepared statement follows:]

STATEMENT
on
TREATMENT OF SOFTWARE LICENSING INCOME EARNED BY A FOREIGN SALES CORPORATION
scheduled for hearings before the
SUBCOMMITTEE ON SELECT REVENUE MEASURES
of the
HOUSE COMMITTEE ON WAYS AND MEANS
as part of their hearings on
MISCELLANEOUS TAX PROPOSALS
on
June 24, 1993
on behalf of
The FSC Software Coalition
by
General James A. Abrahamson, Chairman of the Board
Oracle Corporation

I am James A. Abrahamson, Chairman of the Board of Oracle Corporation. Accompanying me today is Steve Keating, Vice President of Tax of Computer Associates. Oracle and Computer Associates are members of a coalition that also includes Autodesk, Borland, Cadence, Comshare, Lotus, Novell, Sybase, Wordperfect, the American Electronics Association (which includes more than 600 software companies in its membership), and the Informaton Technology Association of America (which includes approximately 500 software companies in its membership). The FSC Software Coalition supports a legislative proposal that would make clear that exports of software are not denied the foreign sales corporation (FSC) benefits available to other exports. Specifically, the coalition supports a proposal to amend the FSC rules to make clear that exports of software qualify for FSC benefits even when accompanied by a right to reproduce.

President Clinton has emphasized the importance of high technology industries to the future economic strength of the United States. In the 1980's the high technology industry focused on advancements in hardware. In the past few years, however, attention has turned to software. Computer software includes both the system software and applications software that enable the computers to perform faster and more varied functions. Today, the United States is the world leader in software development and employs approximately 400,000 people in the United States in high-paying software development and servicing jobs. To stimulate the creation of more of these high-paying software industry jobs in the United States, the Commerce Department has been encouraging software companies to export. The Commerce Department estimates that every $1 billion of export trade is worth 19,000 domestic jobs.

Unfortunately, the IRS has taken a position in direct conflict with the Administration's position to encourage software companies to export. The tax code, through the FSC rules, currently allows a benefit for U.S. exporters of goods developed in the United States. The Congress enacted the FSC rules to encourage exports. However, due to a narrow IRS interpretation of the FSC rules, the export of computer software that is accompanied by a right to reproduce the software is barred from receiving this export incentive. This interpretation appears to unfairly discriminate against exports of software since master recording tapes for reproduction outside the United States are not denied FSC benefits; it has the effect of denying FSC benefits to most software exporters because it ignores the way the software industry does business and how information technology is and will be transmitted in the future.

Computer software is an important and growing U.S. export. Congress should clarify that the FSC rules apply to exports of computer software, whether or not accompanied by a right to reproduce.

Contributions of the Computer Software Industry

The computer software industry makes significant contributions to the U.S. economy.

1. The computer software industry in the United States employs thousands of highly-skilled and highly-paid computer programmers to develop the computer software that is its product. These high-wage, high-skilled jobs are the type of jobs that President Clinton and members of
2. The computer software industry in the United States invests heavily in research and development to create new products for its markets. This helps both to create new technologies and advance existing technologies, resulting in the United States being a world leader in the development of new technologies.

3. The software industry in the United States produces a product that is in high demand both in the United States and abroad. The demand for U.S. developed software outside the United States has led to a surge in the exports of U.S. software, which has been actively encouraged by members of President Clinton's Administration. These exports reduce the trade deficit of the United States and help expand the markets for American-made goods, resulting in more high-paying jobs for computer software programmers and others in the United States.

The computer software industry in the United States is currently a world leader in its industry. However, like other U.S. exporters, the software industry needs the FSC benefits to remain competitive. The FSC benefits also encourage small and medium-sized software companies to enter the export market, by helping them to equalize the cost of exporting. However, many foreign governments have realized the importance of the computer software industry today and in the future. These foreign governments are actively working to attract computer software developers to their countries by offering various incentives. If the efforts of these foreign governments are successful they will:

- take away the high paying jobs of U.S. workers,

- replace the United States as a leader in an important industry in the future, and

- transform an industry that produces a trade surplus for the United States into another industry the products of which we import from foreign manufacturers.

How the Computer Software Industry Conducts Business

Computer software programmers conduct research and development activities in the United States for the development of software products. These software programmers are highly-skilled and highly-paid employees who add significant value to the computer software product. The U.S. company licenses the software to customers in the United States and in foreign countries.

A U.S. company that markets its computer software usually licenses a master tape of the computer software to foreign subsidiaries, third party distributors, original equipment manufacturers (OEMs) and value-added resellers (VARs). The distributors may translate the software into the language of the local country and reproduce it for license to customers in that country. In addition, software may be licensed through OEMs who put the software into their hardware and sell the bundled package of software and hardware. In other cases, software may be licensed to VARs, who add their own software product to the purchased software and then reproduce the combined product for sale. These are all important distribution networks for exports of software and greatly enhance the exports of U.S. software. Because software programs are constantly evolving, large inventories of software are not maintained. Rather, distributors, OEMS and VARs often make individual copies of the computer software as needed.

Computer software manufacturers are increasingly entering into "site licenses" with some of their larger customers. A site license is the licensing of a master tape of the computer software directly to the customer. The customer may then make hundreds or thousands of individual copies of the master tape as required by its various employees and locations. Large foreign companies often prefer to do business with local corporations (i.e., foreign subsidiaries of U.S. companies). In these instances, the U.S. company will transfer the master tape of the computer software to a foreign subsidiary that will enter into the site license with the foreign customer.

Discussion

In 1971, Congress enacted the Domestic International Sales Corporation (DISC) legislation to encourage the exportation of U.S. manufactured goods in order to help U.S. companies compete in overseas markets and so improve the nation's balance of payments. Additionally, by encouraging the export of U.S. manufactured goods Congress hoped to keep high paying manufacturing jobs in the United States as well as create new manufacturing jobs. In 1984, the DISC provisions were replaced by the FSC rules. The FSC rules had the same purpose as the DISC rules, but eliminated some of the provisions in the DISC rules that our trading partners found objectionable.

Under the FSC provisions, the export of certain intangibles are not eligible for FSC benefits. Section 927(a)(2)(B). Specifically excluded are "patents, inventions, models, designs, formulas, or processes, whether or not patented, copyrights (other than films, tapes, records, or similar reproductions, for commercial or home use), goodwill, trademarks, trade brands, franchises, or other like property." This language is identical to the language contained in the DISC statute written in 1971 (see section 993(c)(2)(B)). Neither the statute nor the legislative history contain any language that specifically precludes the application of the DISC or FSC to software. The legislative history to the FSC provisions provides no explanation of this section of the bill. The legislative history to the DISC provides only the following explanation of this section of the bill:

> Although generally the sale or license of a copyright does not produce qualified export receipts (since a copyright is generally not export property), the sale or lease of a copyrighted book, record, or other article does generally produce qualified export receipts. House Report No. 92-533, 92nd Cong., 1st Sess. 69 (1971), 1972-1 C.B. 498, 535; Senate Report No. 92-437, 92nd Cong., 1st Sess. 102 (1971), 1972-1 C.B. 559, 616.

Treasury regulations interpreting the DISC rely on this legislative history in providing that a copyrighted article (such as a book) if not accompanied by a right to reproduce it is export property. The regulations also state that a license of a master recording tape for reproduction outside the United States is qualified export property.

> Export property does not include any patent, invention, model, design, formula, or process, whether or not patented, or any copyright (other than films, tapes, records, or similar reproductions, for commercial or home use), goodwill, trademark, tradebrand, franchise, or other like property. Although a copyright such as a copyright on a book does not constitute export property, a copyrighted article (such as a book) if not accompanied by a right to reproduce it is export property if the requirements of this section are otherwise satisfied. However, a license of a master recording tape for reproduction outside the United States is not disqualified under this subparagraph from being export property. Reg. §1.993-3(f)(3).

The eligibility of computer software for DISC export benefits was first questioned in 1985 when the IRS National Office was requested to provide technical advice on whether so-called "box top" or "shrink-wrap" computer software sold or leased outside the United States on a mass market basis qualified for DISC benefits. In Technical Advice Memorandum 8549003, the IRS stated:

> The "films, tapes, records, or similar reproductions" language of section 993(c)(2)(B) is not limited as to subject matter. Since copyrighted computer software is marked on magnetic tapes for commercial use, such tapes seem to specifically qualify based on the Code language. However, it is unclear whether Congress intended this provision to apply to other than entertainment industry tapes. Based upon the earlier drafts of section 993(c)(2)(B), it could be argued that Congress intended qualification for only tapes that are like films or records, i.e., videotapes or musical tapes. See H.R. 18392, 91st Cong., 2d Sess. (1970) and H.R. 18970, 91st Cong. 2d Sess. (1970), in which the proposed version of the parenthetical exception of finally enacted section 993(c)(2)(B) only applied to films and tapes produced by the entertainment industry. However, one could also argue that since the finally enacted provision does not seem to be solely limited to the entertainment industry, such provision should not be interpreted in a restrictive manner. [Emphasis added].

Without concluding whether computer software on magnetic tape was meant to be within the parenthetical exception to section 993(c)(2)(B), the IRS concluded that the software in issue was

eligible for DISC benefits because the provisions seemed to include as export property finished products or inventory items.

In a later technical advice memorandum, the IRS more decisively reached the conclusion that the parenthetical exception in section 993(c)(2)(B) did not seem to be limited to the entertainment industry, and, therefore, the provision should not be interpreted in a restrictive manner. However, in ruling that the computer program tapes in this case, which were produced in the United States and sold or licensed outside the United States on a mass market basis, were qualified property, the IRS relied on the regulations under the DISC rules, which permitted copyrighted books to qualify for DISC. (TAM 8652001)

Although it seems clear that computer program tapes qualify as "tapes" under Sections 993(c)(2)(B) and 927(a)(2)(B), the phrase "similar reproductions" also is broad enough to include the licensing of computer software. This is because the production of a master computer software tape, the medium and the manner in which it is reproduced and distributed is very similar to the manner in which the entertainment industry distributes its product to the market. For example, it is common for both films and software master tapes to be exported to distributors who will translate the tape into the local language and reproduce it for distribution in that country. Furthermore, the direction the technology is taking is that distribution of films, tapes, records, videos, software and any other type of digital information will be by electronic impulse rather than by shipping copies. Thus, the language chosen by Congress for the parenthetical exception was intended to be broad enough to encompass exports, like computer software, that are exported in the same manner as films and records.

Despite these IRS opinions and the broad language of the statute, the temporary FSC regulations issued in 1987, interpreting language identical to that interpreted by these opinions, adopted a narrow interpretation of the parenthetical exception and denied any FSC benefits for the license of computer software if the license is accompanied by the right to reproduce the computer software.

The FSC regulations substantially parallel the DISC regulations. However, regulation writers in 1987, now cognizant of the existence of the software industry, decided to specifically address software in regulations promulgated under FSC. The regulations writers made a determination to treat mass marketed computer software as a copyrighted article that is eligible for FSC benefits. They also made a decision not to treat a license of a software program for reproduction outside the United States like a master recording tape, which is also eligible for FSC benefits. In these regulations, the IRS effectively narrowed the scope of property eligible for FSC benefits to exclude a major portion of software exports -- licenses of computer software with the right to reproduce. Temporary Regulation §1.927(a)-1T(f)(3), which defines intangible property that is excluded from the definition of FSC export property, states:

> Export property does not include any patent, invention, model, design, formula, or process. whether or not patented, or any copyright (other than films, tapes, records, or similar reproductions, for commercial or home use), goodwill, trademark, tradebrand, franchise, or other like property. Although a copyright such as a copyright on a book or computer software does not constitute export property, a copyrighted article (such as a book or standardized, mass marketed computer software) if not accompanied by a right to reproduce for external use is export property if the requirements of this section are otherwise satisfied. Computer software referred to in the preceding sentence may be on any medium, including, but not limited to, magnetic tape, punched cards, disks, semi-conductor chips and circuit boards. A license of a master recording tape for reproduction outside the United States is not disqualified under this paragraph from being export property. Temp. Reg. §1.927(a)-1T(f)(3). [Emphasis Added]

IRS effectively narrowed the scope of property eligible for FSC benefits to exclude a license of computer software with the right to reproduce.

The narrowing of the definition of export property to exclude computer software licenses that permit reproduction of the software has no basis in the statute or legislative history to the DISC or FSC rules, but was based on an administrative decision by the FSC regulation writers at the IRS that computer program tapes were neither "tapes" nor "similar reproductions" within the meaning of the statute. Despite the fact that the legislative history provides no basis for limiting

these terms within section 927(a)(2)(B)'s parenthetical to the entertainment industry, the IRS regulation writers made a decision to do so. Not only does this ignore the way that software is exported, it ignores the similarities between the film, record and computer software industries. The future direction, driven by technology, is that digital information, whether it be music, video, or computer software will all be transmitted in the same way. No logical distinction has ever been made between the two industries because there is none.

Congress' statute, specifically allowing for "similar reproductions" to qualify for DISC and FSC treatment, recognized the need for the legislation to address developing industries and means of doing business. The IRS regulations do not. The IRS' position for taking such a narrow view in their regulations is that computer software was not specifically mentioned in the FSC statute. But the FSC provision in this area is identical to the DISC provision in this area that was written in 1971 when software was in its infancy. We believe that the administrative decision not to treat software like recordings in the FSC regulations because software was not specifically mentioned in the 1971 DISC statute or regulations is incorrect.

The software industry is seeking a legislative clarification that exports of software, whether or not accompanied by a right to reproduce, are eligible for FSC benefits. We believe this reflects Congress' original intent in enacting the FSC rules. We do not believe that Congress in enacting the FSC rules intended to provide a benefit to the entertainment industry but not to the software industry, which manufacturers and distributes its product in a similar manner. The industry believes that the regulations are invalid and will litigate their position, but we believe it will save both taxpayers and government money if this issue is clarified so that protracted and costly litigation can be avoided.

Summary

The computer software industry is important to the economy of the United States today and in the future. The computer software industry creates high-paying jobs in the United States, helps the United States to maintain its position as a world leader in the high technology field and is a large and growing source of U.S. exports, the revenue from which reduces the U.S. trade deficit. The failure to permit exports of computer software to qualify for FSC treatment is counterproductive and inconsistent with the U.S. interest in fostering the continued growth of this industry in the United States. In addition, there is no tax policy reason for denying exporters of software the tax benefits of the FSC rules that are available to other U.S. exporters and in particular the film and record industries, which operate in a similar manner. There is a need for Congress to clarify the original intent of the DISC and FSC legislation to encourage U.S. exports, including software, in light of the Treasury Department's temporary FSC regulations. Therefore, we respectfully request that Congress enact legislation which would clarify that the definition of FSC export property includes the license of computer software to foreign distributors and customers with the right to reproduce.

Chairman RANGEL. Mr. Mattson.

STATEMENT OF ROBERT MATTSON, ASSISTANT TREASURER, IBM CORP., ON BEHALF OF COMPUTER & BUSINESS EQUIPMENT MANUFACTURERS ASSOCIATION

Mr. MATTSON. Thank you, Mr. Chairman and members of the committee. My name is Bob Mattson. I am assistant treasurer of IBM, responsible for the company's worldwide tax operations.

I appreciate the opportunity to testify on behalf of the Computer & Business Equipment Manufacturers Association (CBEMA), about ways to simplify and improve the effectiveness of the foreign tax credit.

CBEMA members are the leading providers of information technology products and services in the areas of computers, business equipment and telecommunications. CBEMA companies had combined sales of more than $270 billion in 1992, nearly 5 percent of our Nation's GNP. We employ over 1 million people in the United States who perform over one-fifth of all U.S. industrial funded research development.

I cannot emphasize enough the fact that more than 50 percent of CBEMA's U.S. members' revenues are derived from overseas operations. In recent years, the U.S. international tax rules have become much more complex and have caused considerable uncertainty which has resulted in an increase in tax controversies which often take years if ever to resolve.

Frequent changes in U.S. tax law have created a patchwork system of rules resulting in great difficulties for companies to effectively use the foreign tax credit for its original and proper purpose, to avoid double taxation of foreign income.

While it is probably best to undertake a comprehensive review of the entire foreign tax area, in the interim we urgently need the committee to act favorably on three proposals to make the foreign tax credit more effective now.

Most important is the extension of the existing foreign tax credit carryover to 15 years. This proposal was included in the foreign income tax rationalization and simplification bill of 1992, and would allow U.S. companies a better chance to avoid double taxation.

It would alleviate the timing problems caused by the lengthy period it takes to resolve double taxation disputes through the competent authority tax treaty process. This problem is particularly harsh for taxpayers in cyclical industries which experience substantial operating losses in some years.

Since this is only a carryforward proposal, there would be no immediate revenue impact, and the impact in any future year should not be a significant revenue problem.

Next, we agree with Congressman Thomas that it is important that the State income tax be allocated solely to U.S. sources. The proposal to allocate all State and local taxes to U.S. sources is not only simpler, it is also correct.

The final provision I wish to comment on is the need to increase the reporting threshold for stock ownership of a foreign corporation. Section 6046 requires U.S. shareholders to file information returns reporting a 5 percent or more investment in foreign corporations. Extensive information must be provided on form 5471, con-

sisting of income statements, balance sheets, costs of goods sold, taxes paid or accrued, and other information for each and every one of these entities.

Ironically, this 5 percent investment threshold is not relevant for any other U.S. tax purpose.

In contrast, there are existing requirements for similar information at the 10 percent investment level.

The reporting threshold under 6046 should be raised to 10 percent. The resulting simplification and burden reduction for taxpayers would not jeopardize either Treasury or IRS informational interests as confirmed by the Treasury Department's International Tax Counsel in a May 1992 letter to Senator Baucus.

In addition, we recommend that you add a de minimis dollar exception based on a foreign investment of no more than $500,000. Our industry often has to take small equity positions in local distributors to insure access of our products to the marketplace, and the paperwork of reporting these small amounts is overly burdensome.

Finally, I would like to take a moment to give you CBEMA's views on simplification using IBM as an example.

IBM's compliance with U.S. tax laws covering our foreign operations is an immense and very costly task. Information request packages are sent by IBM U.S. to over 120 non-U.S. country companies. This generates over 3,000 separate reports returned to our tax compliance group in the United States. U.S. tax law requires our country companies to each prepare 31 different reports with many hours of labor on their part overseas.

The tax reports from each foreign entity must be examined and cross-checked to verify accuracy. This information, after months of work, is manually transferred to IRS tax forms 1118s for foreign taxes and hundreds of 5471s for each entity. IBM employs 24 tax professionals plus a number of part-time college students working over an 8-month period, often requiring overtime, to accomplish this task for each year, and the IRS will probably expend over three-person years per year of work reviewing this information.

Unfortunately, at the completion of all this work, we still don't know whether we got it right. And I can assure you the IRS cannot deal with the complexity.

It is time to begin to fix this wasteful process, and we urge passage of these provisions to help achieve this.

Again, thank you for the opportunity to appear before you, and I would be happy to answer any questions you have.

[The prepared statement and attachment follow:]

Statement of
Computer and Business Equipment Manufacturers Association (CBEMA)

Presented by
Robert Mattson
Assistant Treasurer, IBM

Mr. Chairman and members of the Committee, my name is Bob Mattson. I am Assistant Treasurer of IBM, responsible for the Company's worldwide tax operations. I appreciate the opportunity to testify on behalf of the Computer and Business Equipment Manufacturers Association (CBEMA) about ways to simplify and improve the efficiency of the foreign tax credit.

CBEMA members are the leading providers of information technology products and services in the areas of computers, business equipment and telecommunications. CBEMA companies had combined sales of more than $270 billion in 1992, nearly 5 % of our nation's GNP. We employ over 1 million people in the U.S. and do over 1/5th of all U.S. industrial funded research and development.

CBEMA members derive more than 50% of their aggregate revenues from overseas. Thus, their economic health depends on U.S. policies aimed at facilitating their efforts to compete internationally. A key to this success is avoiding economic double taxation on international transactions and on the repatriation of foreign subsidiary earnings. The U.S. foreign tax credit system has in the past served this purpose quite well. However, in recent years the international tax rules affecting U.S. companies doing business abroad have become much more complex and have caused considerable uncertainty. The result has been an increase in multi-jurisdictional tax controversies which often take many years, if ever, to resolve. In addition, frequent changes in U.S. tax legislation and regulations in the foreign area have created a patchwork system of basketing and allocation rules which create great difficulties for companies to effectively use the foreign tax credit for its original and proper purpose: to avoid double taxation on foreign income.

While it would be best to undertake a comprehensive review and revision of the entire foreign tax area, in the interim, we urgently need this Committee to act favorably on these proposals to make the foreign tax credit more effective now.

1. Extend the Existing Foreign Tax Credit Carryforward of Excess Foreign Taxes to 15 years

This proposal was included in H.R. 5270, the Foreign Income Tax Rationalization and Simplification Bill of 1992, so you will already be familiar with the necessity of this change. Fifteen year carryforwards are found in other sections of the tax code such as carryforward provisions for net operating losses.

This provision to extend the existing carryforward from 5 to 15 years would allow U.S. companies a better chance to avoid double taxation. It would alleviate the timing problems caused by the lengthy period it takes to resolve double taxation disputes through the competent authority/treaty process. This problem is particularly harsh for taxpayers in cyclical industries which experience substantial operating losses in some years. For example, the years 1991 and 1992 were extremely difficult for our industry and we ask that you provide an effective date for this change beginning January 1, 1991.

Since this is only a carryforward proposal, there would be no immediate revenue impact, and the annual impact in any future years should not be a significant revenue problem.

2. Allocate State Income Taxes to U.S. Sources

States may not tax income which does not have a connection or "nexus" with the State. Generally, foreign income does not have such a nexus. Yet the IRS has ruled that State income taxes should be apportioned against foreign source income for purposes of computing the foreign tax credit. This has the effect of severely limiting the effectiveness of the foreign tax credit by not allowing it to be used for a portion of foreign source income that has been taxed abroad.

The present Treasury Regulations require a detailed analysis of how each State's tax base (determined under State or local law) treats income that for federal purposes would be foreign source income. This analysis is very costly to administer; it is complex and results in double taxation since the State taxes so allocated would not be a valid tax deduction in any foreign jurisdiction. The proposal to allocate all state and local taxes to U.S. sources is not only simpler but correct.

Another proposal we comment on is one of simplification where both taxpayer's and the IRS's cost of compliance would go down without any exposure to the tax base.

3. Increase the Reporting Threshold for Stock Ownership of a Foreign Corporation

Present law (IRC Section 6046), adopted in 1962, requires U.S. shareholders to file information returns reporting 5% or greater acquisitions or increases in investment amounts in foreign corporations, or reductions to an existing investment to under 5%. Extensive information must be provided on Form 5471 consisting of income statements, balance sheets, costs of goods sold, taxes paid or accrued. U.S. persons who become officers also have to file information returns.

Ironically, this 5% investment threshold for filing is not relevant to any other U.S. tax purpose and creates enormous administrative complexity for taxpayers and the IRS as well.

In contrast, there are existing requirements for similar information at the 10% level in the case of the indirect foreign tax credit. We believe that the reporting threshold should be raised to 10%. The resulting simplification and burden reduction for taxpayers would not jeopardize either Treasury or IRS informational interests as confirmed by their International Tax Counsel in a May 1992 letter to Senator Baucus (attached). In addition to the increase to 10%, we recommend that you also consider adding a de minimus dollar exception based on an investment of $500,000. Our industry often has to take small equity positions in local distributors to insure access of our products to the market place, and the paperwork on reporting these small amounts is quite burdensome.

4. Modify the Current Subpart F Rules to Encourage Expansion into the European Community

We also support H.R. 1401 which would remove a major obstacle to effective competition by U.S. multinational corporations in the emerging unified market of the European Community (EC). Under H.R. 1401, the subpart F rules of the Internal Revenue Code of 1986 would be amended to treat the twelve European Community

countries as a single country for purposes of determining foreign-base company sales and services income.

Our European and Japanese competitors are streamlining their EC operations to take advantage of the new unified markets, but under subpart F, U.S. multinationals must create costly and duplicative subsidiaries in each European Community country or be subject to a current U.S. tax on earnings before they are actually repatriated to the U.S. parent. The original purpose of subpart F — to deter U.S. companies from establishing subsidiaries in tax haven countries merely to avoid U.S. taxation of income — has been preserved in H.R. 1401, but the obstacles to competition have been removed.

I would like to take a moment to give you CBEMA's views on simplification using IBM as an example. IBM's compliance with U.S. tax laws covering our foreign operations is an immense and very costly task. Information request packages are sent by IBM U.S. to its over 120 non-U.S. country companies. This generates over 3,000 separate reports returned to our tax compliance group in the U.S. U.S. tax law requires our country companies to each prepare 31 different reports. The tax reports from each foreign entity must be examined and cross-checked to verify accuracy. An elaborate computer software program with numerous modules is employed to assist our tax accountants in this enormous effort. Finally, this information after months of work is manually transferred to IRS Tax Forms 1118's for foreign taxes and hundreds of 5471's for each entity investment. IBM employs twenty-four tax professionals plus a number of part-time college students working over an eight month period (often requiring overtime) to accomplish this task; and the IRS will probably expend over 3-person years of work reviewing this information.

In addition to these matters, there are two important and non controversial changes contained in H.R. 13, the Tax Simplification bill, which you introduced earlier this year, and which were a part of H.R. 11 last year: namely (1) extension of the indirect foreign tax credit to the sixth tier and (2) a grant of regulatory authority to the Treasury Department to issue regulations allowing foreign taxes paid to be translated at the average exchange rate for the year of payment. CBEMA strongly supports these moves to further simplification and hopes that at the appropriate time the simplification bill can be added to the larger budget reconciliation bill.

Mr. Chairman, it is time to begin to fix this wasteful process and we urge passage of these provisions.

Again, thank you for the opportunity to appear before you. I believe these items will be very helpful to our industry, and indeed all of the U.S. business community competing in the international market place. There should not be any appreciable revenue costs to achieve this simplification and to make the foreign tax credit more efficient.

I would be happy to answer any questions you may have.

LLOYD BENTSEN, TEXAS, CHAIRMAN
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EDMUND J. MIHALSKI, MINORITY CHIEF OF STAFF

United States Senate
COMMITTEE ON FINANCE
WASHINGTON, DC 20510-6200

October 30, 1991

Mr. Graham Clark
Chief
International Enforcement Division
International Programs IRS
950 L'Enfant Plaza South, S.W. Room 4409
Washington, D.C. 20024

Dear Mr. Clark:

Earlier this year I introduced S. 936, a bill which would substantially reduce the complexity of the Internal Revenue Code's foreign provisions. I am currently weighing the merits of a number of additional proposals for possible inclusion in the foreign simplification package. It would be very helpful to have the views of your office regarding one of these proposals in particular. Specifically, I am referring to a proposal which would amend Section 6046 of the Code.

As you know, Section 6046 sets forth reporting requirements applicable to U.S. corporations in certain situations involving five percent stock transactions. Any U.S. corporation which has acquired, directly or indirectly, in one or more transactions, five percent or more of the value of the outstanding stock of a foreign corporation, or which owns as much as five percent of the foreign corporation's stock at the time of a reorganization of the foreign corporation, or that disposes of sufficient stock in the foreign corporation to lower its interest to less than five percent must report the transaction to the Internal Revenue Service. This reporting requirement entails the completion and submission of specified sections of Form 5471.

Under the proposed amendment to Section 6046 being considered, the five percent threshold would be raised to ten percent. Obviously, this should result in a substantial decrease in the number of Forms 5471 submitted to the Service, and would therefore alleviate complexity for everyone. However, before endorsing this proposal, I would like to be confident that raising the stock threshold to ten percent from five percent as proposed would not be inconsistent with the legitimate requirements of the Service regarding information reporting in this context. I would appreciate having your views about the value to your office of the reporting information currently required under the statute in five percent situations, and whether raising the threshold to ten percent would be appropriate. Your attention to this matter is greatly appreciated.

Sincerely,

Max Baucus

DEPARTMENT OF THE TREASURY
WASHINGTON

MAY 19 1992

The Honorable Max Baucus
United States Senate
Washington, D.C. 20510-3400

Dear Senator Baucus:

Thank you for your letter of October 30, 1991 to Graham Clark at the Internal Revenue Service concerning a proposal to raise the threshold of stock ownership required for reporting under section 6046 of the Code from five percent to ten percent. I am responding to your letter because it raises issues of international tax policy. I am sorry for the extreme delay in answering your inquiry.

As you know, section 6046 requires a direct or indirect shareholder of a foreign corporation to file a Form 5471 to report corporate financial information both in the year of the acquisition of five percent or more of the value of the corporation's shares and in subsequent years if an additional five-percent block of shares is acquired. That section also requires reporting of financial information in the year that the foreign corporation is reorganized or the U.S. shareholder disposes of sufficient number of shares to lower its ownership interest below five percent. Similar reporting requirements are imposed on U.S. citizens and residents who are officers or directors of such foreign corporations.

The information collected under section 6046 is valuable for the administration of the income tax laws. In the event of an audit, it is essential for the IRS to have basic information about the overall corporate structure of a particular U.S. taxpayer's foreign operations. Raising the reporting threshold to ten percent, however, does not appear to jeopardize this interest, and it would simplify reporting by U.S. taxpayers owning minority interests in foreign subsidiaries. Raising the threshold might also reduce the risk of inadvertent noncompliance by minority shareholders with a less than ten-percent indirect interest, who may have particular difficulty monitoring these investments. In this regard, however, I would note that taxpayers have never complained that they have difficulty monitoring their investments for purposes of the indirect foreign tax cred under section 902, which may be available to a U.S. corporate parent with respect to five-percent investment in a second- or third-tier foreign subsidiary.

Accordingly, a proposal to raise the section 6046 reporting threshold to ten percent should be given serious consideration because it is likely to achieve some simplification and burden reduction for some taxpayers without jeopardizing either Treasury or IRS informational interests.

Sincerely,

Philip D. Morrison
International Tax Counsel

Chairman RANGEL. Are you aware, Mr. Mattson, of any objections that Treasury would have to your recommendations?

Mr. MATTSON. Yes. Obviously, the second recommendation which Congressman Thomas brought up is to override the Treasury regulation. That has to do with State income taxes being allocated solely to the United States.

The third provision——

Chairman RANGEL. They indicate that in their belief that is a mismatch of expenses and related income.

Mr. MATTSON. Well, if you go to the laws of the 50 States—they can only tax income within their nexus.

Now, if they decide to use some foreign income as a base, to get the numbers right, they are not really taxing foreign income, they are only, again, arguing to tax their base. And, of course, there are Supreme Court cases now pending in California and eight other States that put foreign income in their base.

So we have a fundamental argument with the Treasury, and the States as well. The unitary States argue and have made summations that say they do not tax foreign income. This is their unique accounting method. While the other nonunitary States don't tax foreign income, they don't, either.

They have to take that position because, otherwise, it is unconstitutional. They would be taxing income outside their nexus.

Chairman RANGEL. Your proposal to extend the carryover period for excess foreign taxes, how would this improve the competitive nature of your business?

Mr. MATTSON. Well, number one, most credits are carried forward for 15 years, as are all the business credits, for example, research and development. The AMT credit is an unlisted carryover.

IBM has had some problems in the United States in 1990, 1991, and 1992; now we find we have problems in Europe. You can't match those different cycles and cyclical problems and get out from under lost credits within 5 years. You need a longer period of time. And we are going through a difficult recovery time, as the whole industry is right now, and the 5-year period puts us in great jeopardy of losing substantial foreign tax credits.

Chairman RANGEL. Thank you.

Mr. McCloskey, the committee has been informed that our trade policy as relates to foreign competitors is under some type of a review. Are you familiar with that? Are you participating in the problems being addressed by our current trade policy with U.S. industry and foreign competitors?

Mr. MCCLOSKEY. We are in many forms. I am not sure which particular one you are referring to.

Chairman RANGEL. I think the Treasury is supposed to be conducting one. We will give you information on that to see whether or not any of their recommendations might be helpful to the problems you presented here.

Also, there is concern about what you have testified—that foreign military sales be monitored by other means. Do you know what other means would be available to monitor those?

Mr. MCCLOSKEY. Well, they are monitored now by the Arms Export Control Act and the overall export license process.

Chairman RANGEL. Is that what you were referring to, existing law?

Mr. MCCLOSKEY. Yes. In other words, there is a decision made as to whether a proposed sale is consistent with U.S. policy or not,. It is our view that sales that are approved under this process ought to be as competitive as they can be and shouldn't be distinguished from comparable commercial sales under the FSC.

Chairman RANGEL. Thank you.

Mr. Mattson, I assume that you are supporting Mr. Farren's proposal that we treat the EC—was that included in the closing part of your testimony?

Mr. MATTSON. It was in my testimony. I saw the red light, and I didn't get a chance to get to it.

Yes. What business needs is flexibility, and that is all it is. Why should we be straitjacketed to have rules that cause punitive tax results which don't affect any other foreign corporations?

A large Japanese computer company or copier company wants to organize their business management as they wish in Europe. U.S. law prevents this. Those Japanese companies can get the leanest, most competitive, cost conscious operation they can have, where a U.S. company just can't.

Chairman RANGEL. Mr. Farren, you were suggesting that we treat the EC as one entity?

Mr. FARREN. Yes, Mr. Chairman. For tax purposes, yes.

Chairman RANGEL. And is this type of thinking going into Pacific Rim countries and Latin American countries in dealing with——

Mr. FARREN. No, Mr. Chairman. This is simply focused on the European Community, and it is a reflection of the needs arising as a result of their economic integration.

Chairman RANGEL. General Abrahamson, I have been advised here in writing that Treasury had already testified that they are moving with an interagency task force reviewing our export programs. Is your industry participating in that? It is my understanding that they want to make certain that we are competitive and that there are many more agencies involved other than Treasury and that they want to get a level playing field. Are you familiar with that at all?

General ABRAHAMSON. Sir, I am not. The members of our coalition and the industry itself, obviously, would welcome an opportunity to participate. Nonetheless, I think the issue has been around for some time. I think it is fairly straightforward, and I would hope that the task force would not become an excuse just to delay what is truly urgently needed action at this point.

Chairman RANGEL. OK. Well, maybe you can make a better judgment when we all find out exactly the area where they are moving because their position is that it is not just a tax matter that we have to perfect. They want to make certain that they have an overall policy to improve competition. You may be right, but I am asking you to check with staff so that you would know specifically what Treasury is talking about.

Mr. Payne.

Mr. PAYNE. Thank you very much, Mr. Chairman, and thank you all for your testimony.

Mr. Mattson, you talked a little bit about simplification and specifically talked about the fact that there were 24 tax professionals who were working. I would assume that is just on foreign tax provisions?

Mr. MATTSON. That is on the whole foreign-gathering of information, preparing of the return, preparing—we have a stack of 5471s because we have to prepare a whole set of papers on every entity in which we invest 5 percent or more.

In Italy, for instance, we take hundreds of very small dollar investments in marketing companies just because it is the way business is done there. I have to prepare a report on every one of those. There is no other reason in the world that that is used for, so we have to gather all that information. In fact, I have a number of college co-ops to help us on that, too, plus all the foreign tax credits. We have to translate every receipt from 120 companies.

In some countries you get tax receipts monthly on every lease. Every one of those has to be translated. There are terrible foreign translation rules right now which is what was in H.R. 13 to correct. We hope that goes forward. You have to translate the language.

I mean, this is just a time consuming—the IRS doesn't know what the heck to do with this stuff. They don't even know why the government even requires it. So there is a lot of simplification that you could do to just get us out of paper burden.

Mr. PAYNE. As an international corporation I am sure you work with other countries and their tax laws and tax provisions as well. Are there other models, other systems that you are familiar with that would be worthwhile for us to take a look at as ones that are more streamlined, work better? Would you comment on value-added taxes and what a concept like that might mean in terms of streamlining or simplification?

Mr. MATTSON. Well, there are value-added taxes in Europe and around the world. We deal with them outside the United States. They are simple to deal with.

It is not so much that the corporate income tax in the United States is the problem. It is the detail in the Tax Code, the technical intricacies, the straitjacket rules that interfere with sound business decisions, the paper load.

The 1986 act was a nightmare for American corporations. I mean, the hundreds if not thousands of pages that you have to deal with on forms and requirements are just a terrible burden. No country in the world would look at our audit trail. IBM today is still in the midst of 1985 and 1986 audits.

We have major companies outside the United States—we have a $8 billion company in Japan. They finished a 1991 audit, and they have just as strict rules as we have but nothing like the technical complexity.

The first thing that has to happen is the IRS has to learn what the rules are. They can't cope with them.

I think Commissioner Richardson, if she hasn't been up here, should be invited here to talk about that.

We have to start on simplification. We can't wait until the whole thing is in one package. And we have offered four or five suggestions as just a beginner. And we think those are first steps. And H.R. 13 is great to start, we think. We compliment you on it.

Mr. PAYNE. Thank you very much. I appreciate that additional information.

Thank you, Mr. Chairman.

Chairman RANGEL. Mr. Hoagland.

Mr. HOAGLAND. General Abrahamson, first, let me notice, as the chairman did, that there does appear to be an interagency task force underway. And it is tough for us, I think, isn't it, Mr. Chairman, to advance matters that are not approved by Treasury?

Chairman RANGEL. It is even tougher when the industry is unaware of the task force.

General ABRAHAMSON. Perhaps the Treasury should publicize their task forces better.

Chairman RANGEL. Well, that is exactly what I meant, General, and we are going to encourage them not only to do it but encourage you perhaps to help us to get the information out to the industry.

General ABRAHAMSON. Thank you, sir.

Chairman RANGEL. Because, as Congressman Hoagland said, we like to believe that our tax policy is catching up with our national policy. And if you are not familiar with what is going on, then it doesn't help us, and it certainly doesn't help the industry.

General ABRAHAMSON. Thank you, Mr. Chairman.

Mr. MCCLOSKEY. Mr. Chairman, I think there is an important point that needs to be made here. There are things that other countries do that create an unlevel playing field for U.S. companies, but there are also a number of things that we do to ourselves in the Tax Code that harm the competitiveness of our companies and industries.

Both in the instance the General is talking about and the instance I am talking about, we find that the burdens we're trying to overcome aren't imposed by foreign countries. Rather, they are barriers created here at home that artificially and detrimentally distinguish between different types of commerce.

In the case of software, it is hard to understand why FSC benefits should be extended to the entertainment industry for the export of master recording tapes used to reproduce various forms of entertainment overseas but not to software companies for software which is exported along with the right to reproduce it overseas. Similarly, Mr. Chairman, I find it hard to justify a different application of the FSC to military and commercial products, especially since so many products have a plain commercial use as well.

We are not even just talking about military products, we are talking about products that could be used as military products but also have a plain commercial use. We are saying that the commercial use, because it is also capable of being used as a military product, disqualified it from the FSC. That is something we do to ourselves.

Chairman RANGEL. I understand what you are saying. But what Mr. Hoagland is saying is that Treasury advised us that they were taking a look at all of the factors that make us less competitive, and, of course, they cannot do this unless you share with them the problems that you are facing with competitors. And so we had falsely assumed that they were reviewing other issues that impede your competition rather than just the area of taxes.

If they haven't invited you to come and to talk, then you can rest assured, if nothing else occurs from this hearing, that we will see that the parties involved meet with Treasury and the other agencies to see that we improve the level of the field.

Mr. MCCLOSKEY. I presume they are referring to and participating in both the special trade representative and the Commerce Department initiatives on trade negotiations, but these don't cover this other aspect of what we do to ourselves.

Chairman RANGEL. I yield back.

Mr. HOAGLAND. It just seems to me, Mr. Chairman, that the next 20 years there is going to be enormous worldwide competition to attract capital to various countries, and we need to simplify and modernize our trade laws, number one, so they are—I mean our tax laws—so they are consistent with our trade policies. And, number two, so we can maximize our ability to retain American capital and not chase it overseas.

I think, Mr. Chairman, there is a lot we can do in this committee to push Treasury along. Because the quicker we can get their interagency task force expanded to include all the areas that need to be included and to appoint a recommendation, the quicker we can act on that.

Mr. Mattson, your testimony—I can tell from your dialog with Mr. Payne and certainly my reaction to it—I think we would like to do as much as we can to accomplish those goals. It is hard to figure out exactly how to do it. If you have any thoughts about that, too, that would be helpful.

General Abrahamson, do you have any revenue loss estimates that are connected with your proposal?

General ABRAHAMSON. The official revenue estimate, I believe, is being worked within the Joint Committee on Taxation, and we don't have the benefit of that.

Informally, we believe that it is large enough to have a significant impact on many of the software companies, but even while recognizing the revenue problem the Nation has, I don't believe it is so large that it would have a substantial impact on the national revenues.

We have an informal estimate that indicates that it is less than $50 million over 5 years, but at this point that is only our estimate. It is not a Joint Tax Committee estimate.

Mr. HOAGLAND. Let me just say in closing, Mr. Chairman, that we are—we constantly hear severe criticisms about the state of our international tax policies, and I think we need to work together as effectively as we can to get those modernized.

Mr. Mattson, your testimony today has certainly been helpful.

Thank you, Mr. Chairman.

Chairman RANGEL. Thank you for all of the members for this very informative information.

We now invite panel number three, Congressman Jefferson is trying to get over here. He wanted so badly to introduce Martin Hyman, who is the president of the Overseas Shipholding Group, who is with Donald Moorhead and Alex Trostoff, both counsel. And this is the Overseas Shipholding Group in New York and the International Shipholding Corp. of New Orleans.

Mr. Jefferson is here, and he can far more eloquently make the introduction of his friend, Mr. Hyman. The chair yields to Mr. Jefferson of New Orleans.

Mr. JEFFERSON. Thank you very much, Mr. Chairman.

Members of the committee, I want to make a brief remark here before——

Chairman RANGEL. Please, those that are leaving try to leave quietly. We are trying to move on with the hearing. Will those in the hearing room please take their conversations in the hallway. The gentleman from New Orleans may proceed.

Mr. JEFFERSON. Thank you, Mr. Chairman.

I am sorry. I was trying to find out a little something here from my staff.

I appreciate the opportunity to introduce the panel that will speak today on the need to reverse a decision made by this Congress in 1986 that is applicable to subpart F, shipping income earned by subsidiaries of U.S. companies on the foreign flag operations.

Mr. Chairman, as you know, we are trying to straighten out some problems in the bill we just passed, the reconciliation bill, to make this Tax Code make some sense and have it be consistent in every area where it has an application to make a consistent application wherever we are dealing with the treatment of foreign-source income.

You notice today the administration has tried to deal with this foreign source income problem by saying that unless the income is repatriated to the country it isn't taxed. The whole proposal here is to bring the U.S.-controlled flagships within that general policy.

Under current law, Mr. Chairman, U.S.-owned foreign shipping companies are taxed on their foreign-source shipping income even though the income is not repatriated to the United States, but rather is invested in foreign businesses. That generally is inconsistent with how we treat other active foreign-source business income and the testimony today is going to reveal how that has worked against our interests.

What has happened is, instead of forcing U.S.-controlled foreign flagships to operate under U.S. flags, it has forced them into arrangements with foreign-controlled operations, driving down our tax revenues and the number of U.S.-flag carriers. That is the problem we are trying to fix.

So in my own district there are three of the seven or so still surviving U.S.-flag carrier operations, and we are privileged in my district to have them there, and we want to keep them there and strengthen them. But, beyond that, we want the policy to be consistent.

So in any event, panel three, Mr. Chairman. I am here to introduce Morton Hyman, who is the president of the Overseas Shipholding Group who will give the testimony this morning. He is accompanied by Donald Moorhead, counsel of the Overseas Shipholding Group, and Alex Trostorff, who is the counsel for the International Shipholding Corp., which is located in my district.

[The prepared statement follows:]

STATEMENT OF THE HONORABLE
WILLIAM J. JEFFERSON
BEFORE THE SUBCOMMITTEE ON SELECT REVENUE MEASURES
JUNE 24, 1993

The U.S. Government has historically relied on foreign-flag vessels owned by foreign subsidiaries of U.S. corporations to meet our nation's sealift requirements in times of war or other national emergency. The U.S.-controlled foreign flag fleet, commonly referred to as the EUSC fleet, has been a vital source of economic support to U.S. parent companies which operate both U.S. flag and foreign flag fleets. The economic viability of those U.S. companies was jeopardized in 1986 when Congress repealed the "reinvestment rule" applicable to Subpart F shipping income earned by subsidiaries of U.S. companies on their foreign flag shipping operations. As a result of that sudden change in the law, the U.S.-controlled foreign flag fleet plummeted from 420 ships in 1986 to only 324 vessels in 1992. This, of course, has had a serious adverse impact on the ability of the United States to meet its essential defense sealift requirements.

Generally, the Internal Revenue Code does not impose a tax on the income of foreign subsidiaries of U.S. corporations unless that income is repatriated. Until 1986, that result could be obtained with respect to shipping income of foreign subsidiaries of U.S. companies that owned EUSC vessels so long as that income was reinvested in foreign shipping operations of that company. After the repeal of that rule in 1986, shipping income of U.S.-controlled foreign-flag vessels became subject to U.S. tax in the year earned, irrespective of whether that income is repatriated to the United States. This departure from pre-1986 law has resulted in a materially greater tax burden on EUSC vessel owners, and thus their ability to compete in international markets has been significantly undermined. Without reversion to the pre-1986 tax law, the strategic EUSC fleet will continue to decline with corresponding revenue losses to the Treasury.

My proposal would restore the pre-1986 tax deferral rule for foreign shipping income of subsidiaries of U.S. parent companies which also own and operate a U.S. flag fleet, provided the foreign shipping income is reinvested in shipping operations. This proposal would eliminate U.S. tax discrimination against merchant vessels controlled by U.S. companies. Reinstatement of the pre-1986 rule is also essential to the business reality that shipping income must be continually reinvested to assure economic viability. Moreover, reversal of the disastrous post-1986 vessel decline is critically important to our national security.

This proposal is consistent with the Administration's proposals on the treatment of foreign source income. It would simply condition tax deferral on the reinvestment of shipping income in shipping operations of the U.S.-controlled subsidiary.

Thank you, Mr. Chairman, for giving me the opportunity to present this statement to the Subcommittee.

Chairman RANGEL. Mr. Jefferson, I have been in the Congress for 23 years, and I have yet to hear a more informative introduction of a witness. That was very well done.

Mr. Hyman, you may proceed if there is anything left.

STATEMENT OF MORTON P. HYMAN, PRESIDENT, OVERSEAS SHIPHOLDING GROUP, INC., NEW YORK, N.Y., ALSO ON BEHALF OF INTERNATIONAL SHIPHOLDING CORP., NEW ORLEANS, LA., AND OMI CORP., NEW YORK, N.Y.

Mr. HYMAN. Well, Mr. Chairman, Mr. Jefferson has not only been very kind in his welcoming remarks, but he has been very eloquent in stating our position. Since the Congressman did say I would testify, I would like to go ahead if I may.

Chairman RANGEL. Of course.

Mr. HYMAN. Thank you. Mr. Chairman, I appear on behalf of a coalition of U.S.-flag shipping companies composed of International Shipholding Corp., OMI, and my company, Overseas Shipholding Group (OSG). OSG is engaged in the ocean transportation of liquid and dry bulk cargoes in both the domestic and worldwide markets. We own and operate nearly 1 million deadweight tons of U.S.-flag vessels. In addition, we have a substantial presence in the foreign trades.

OMI, which like OSG is headquartered in New York, also has a substantial U.S. flag and foreign flag presence in the liquid and dry bulk trades.

ISC, based in New Orleans, is engaged through its subsidiaries in ocean and inland waterborne freight transportation throughout the world.

Mr. Chairman, I am here today to respectfully urge Congress to undo a 1986 change in longstanding tax policy, a change that severely and inequitably penalizes U.S. shipowners and undermines their ability to compete in international markets.

Specifically, the 1986 repeal of the shipping operations reinvestment rule contained in the subpart F provisions of the code subjects shipping income earned by foreign subsidiaries of U.S. corporations to current U.S. taxation, even though the income is reinvested in ships and even though it is not repatriated to the United States.

President Clinton, in his tax proposals which have been passed by this House, would maintain the general policy that income of a controlled foreign subsidiary of a U.S. corporation will not be taxed when the controlled foreign corporation reinvests its earnings in its trade or business abroad. This has been the rule for more than half a century, and this is true today for General Motors, Xerox, Procter & Gamble and almost every other U.S. business.

Other than passive income and services the only exceptions to this general rule are certain kinds of oil and gas industry income and, since 1986, shipping. As a result, the status of the United States as a world shipping power has declined significantly.

Since 1986, while the world bulk fleet has grown from 460 million deadweight tons to over 500 million deadweight tons, the U.S.-owned foreign-flag fleet has declined by a third. The U.S.-owned foreign-flag transportation fleet is now only 5 percent, one-third smaller than it was 7 years ago, and, absent restoration of the sub-

part F exemption, that proportion will continue to drop. This trend will only be reversed by eliminating the 1986 tax change.

Not only has the 1986 tax change created an inequity for U.S. shipowners in relation to other U.S. taxpayers, it has also created an insurmountable and discriminatory burden for U.S. owners as they seek to compete in international markets. Greece, Hong Kong, the Netherlands, the Philippines, Taiwan, Italy, Korea, Denmark, France and, most recently and significantly, Canada all afford their ship-owning nationals the very deferral of taxation that the United States abandoned in 1986. And Japan manages to subsidize and protect its industries, including shipping, in many and perhaps even more subtle ways.

The international bulk shipping markets are highly competitive, with a large number of shipowners facing a large number of charterers. Charter rates are determined by overall market forces. Shipowners cannot charge or reasonably expect to receive a higher charter rate simply because their operating or capital costs are higher than their competitors. The cost of current taxes on unrepatriated foreign earnings cannot be passed on to our customers.

Additionally, and importantly, our industry is highly capital intensive. We must continuously reinvest a significant percentage of our earnings in ships in order to maintain a safe, modern, ecologically sound, and competitive fleet.

Since these earnings became subject to current tax in 1986, U.S. shipowners have had only 66 cents on the dollar available for reinvestment, compared to $1 for our foreign competitors. The response of U.S. owners has been predictable. They have been selling vessels, and they have entered into joint ventures giving foreign owners the majority interest and majority control.

Surely, I believe, we would all agree that maintaining a strong U.S.-owned fleet is a matter of national concern.

Mr. Chairman, we do not seek a special tax concession. We are not asking for protection against the rigors of international competition. We ask only to be put on an equal footing with other U.S. taxpayers and with non-U.S. owners of foreign flag vessels.

To summarize, Mr. Chairman, repeal of the reinvestment rule in 1986 was a fundamental tax law change that reversed more than a half century of U.S. tax policy and since has had and will continue to have a severe adverse effect on our ability to compete in international markets. We, therefore, respectfully urge you to report legislation consistent with the House-passed tax bill to restore the shipping operations reinvestment rule for companies with a qualified U.S.-flag fleet.

I thank you very much, Mr. Chairman.

Chairman RANGEL. Thank you, Mr. Hyman.

[The prepared statement follows:]

STATEMENT OF

MORTON P. HYMAN

PRESIDENT

OVERSEAS SHIPHOLDING GROUP, INC.

ON BEHALF OF

INTERNATIONAL SHIPHOLDING CORPORATION,

OMI CORP., AND

OVERSEAS SHIPHOLDING GROUP, INC.

SUBMITTED TO

THE SUBCOMMITTEE ON SELECT REVENUE MEASURES

UNITED STATES HOUSE OF REPRESENTATIVES

JUNE 24, 1993

I.

Introduction and Summary

I am Morton P. Hyman, President of Overseas Shipholding Group, Inc. ("OSG"). I am appearing on behalf of a coalition of U.S. flag shipping companies comprised of International Shipholding Corporation ("ISC"), OMI Corp. ("OMI"), and my company.

OSG, a Delaware corporation listed on the New York Stock Exchange and headquartered in New York, is engaged in the ocean transportation of liquid and dry bulk cargoes in both domestic and worldwide markets. We are the largest independent owner of unsubsidized U.S. flag bulk tonnage; we own over 10% of the entire unsubsidized U.S. flag fleet. We also have a substantial presence in the foreign trades. OSG charters its ships to commercial shippers and to U.S. and foreign governmental agencies for the carriage of bulk commodities, principally petroleum and related products, grain, coal, and iron ore.

ISC, a Delaware corporation listed on the New York Stock Exchange with headquarters in New Orleans, Louisiana, is engaged through its subsidiaries in ocean and inland waterborne freight transportation throughout the world. ISC's fleet consists of LASH (Lighter Aboard SHip) vessels, car carrier, roll-on/roll-off vessels and similar liner-type vessels.

OMI Corp., a Delaware corporation also listed on the New York Stock Exchange and headquartered in New York, is engaged in the ocean transportation of liquid and dry bulk cargoes in both domestic and worldwide markets. OMI charters its vessels to commercial shippers and to U.S. and foreign governmental agencies for the carriage of crude oil, petroleum products, chemicals, liquefied natural gas, grain, and other dry bulk commodities.

In 1986, Congress adopted a new tax rule that severely penalized U.S. shipowners and undermines their ability to compete in international markets. Specifically, the repeal of the shipping operations reinvestment rule contained in the "Subpart F" provisions of the Internal Revenue Code (the "Code") subjects

shipping income earned by foreign subsidiaries of U.S. corporations to current U.S. taxation. This represented a departure from the general U.S. tax rules applicable to international subsidiaries of U.S. corporations. Given the capital intensive and highly competitive nature of the international bulk shipping trades, current taxation places materially greater tax burdens on U.S. shipowners than are imposed on our principal competitors.

This tax change has had a measurable effect on the vitality of the U.S.-owned international shipping fleet, which has declined substantially. Moreover, the pace of that decline is likely to accelerate over time. Since 1986, the U.S.-owned foreign flag bulk fleet has declined from 36 million deadweight tons ("dwt") to 26 million dwt, while the world bulk fleet has grown from 462 million dwt to 502 million dwt as of the end of 1991 (the most current data). The U.S.-owned foreign-flag portion of the world bulk fleet now is only 5%, one-third smaller than in 1986.

OSG, OMI, and ISC respectfully urge Congress to restore the shipping operations reinvestment rule for shipping companies that operate both U.S. and foreign flag fleets. Restoration of the reinvestment rule would place these enterprises on the same tax footing as other U.S. multinational corporations engaged in active, capital-intensive businesses around the globe as well as our primary foreign competitors.

Restoration of the reinvestment rule would be fully consistent with the Clinton Administration's proposal to permit deferral of tax for foreign earnings reinvested in an active business. Under the Administration's tax proposals--as passed by the House of Representatives--any U.S. shareholder of a controlled foreign corporation will have to include in income a specified amount of the foreign corporation's undistributed income when such corporation has an excess amount of passive assets. Conversely, no current inclusion of income will be required when the controlled foreign corporation invests its earnings in its particular trade or business. Similarly, the proposed Subpart F reinvestment rule is predicated on the same policy of allowing deferral when earnings are used in the active trade or business of a controlled foreign corporation. We therefore respectfully urge the Committee to report legislation consistent with the House-passed tax bill to restore the shipping operations reinvestment rule for companies with a qualified U.S. flag fleet.

II.

The Competitive Environment and Taxation of Shipping

A. Shipping Operations of OSG, OMI and ISC.

OSG, OMI, and ISC operate in both worldwide and domestic markets. We believe that ownership of a diversified fleet, with vessels of different flags, types and sizes, provides operating flexibility and permits maximum usefulness of vessels. For a variety of business reasons, each of our vessels is owned by a separate corporate subsidiary, many of which are organized in foreign countries.

OSG's U.S. flag bulk fleet consists of 16 vessels aggregating approximately one million deadweight tons. ISC's U.S. flag fleet consists of 16 vessels as well. OMI's U.S. flag fleet consists of 19 vessels, 16 of which it owns and 3 of which it charters, for a total of approximately 740,000 dwt. All three companies operate substantial fleets in the foreign trades as well.

By law, U.S. coastwise and noncontiguous shipping is primarily reserved for U.S. flag vessels built here without subsidies and operated without them. The preference trades, primarily grain shipments to foreign governments, employ both subsidized and unsubsidized vessels. OSG's U.S. flag vessels, for example, are employed in the Alaskan oil trade and other domestic petroleum trades, by the U.S. government, in the transportation of motor vehicles and for transporting dry bulk cargo, primarily under P.L. 480. The domestic trade is very competitive, and is principally affected by the levels of domestic crude oil production and oil imports, the volume of oil refining, and the government's requirements for military and grain shipments.

Competition in the foreign bulk shipping markets also is extremely keen. Demand generally is dependent upon international economic conditions, as well as on world oil production and consumption, steel production and grain shipments. Charter rates are determined by market forces and are highly sensitive to changes in supply or demand. Any change in costs, including taxes, can have a direct and adverse impact if it is borne by some but not all carriers.

The economic viability of the international flag fleet has special importance to shipowners operating in both domestic and international trades. For them, income from the international flag fleet provides support for the U.S. flag fleet when domestic markets are under pressure.

B. Taxation of U.S.-Controlled Shipping Income.

Under tax principles of long-standing application, the United States generally does not tax the income earned abroad by separately incorporated controlled foreign subsidiaries of U.S. corporations until such income is repatriated (e.g., as a dividend by the foreign subsidiaries to the U.S. parent corporation). The "Subpart F" provisions of the Code are an exception to this general tax principle and only apply current taxation to narrowly defined types of income. Under the Subpart F exception, which was first enacted in 1962, the principal U.S. shareholders of a U.S.-controlled foreign corporation ("CFC") are taxed on the "Subpart F income" of the CFC in the year such foreign income is earned. Subpart F treats such income as if it had been paid by the CFC as a current dividend to those U.S. shareholders whether or not such income is then (or ever) in fact repatriated. If Subpart F income is repatriated by the CFC in a subsequent year, it is classified as "previously taxed" and is not subject to what would otherwise be a second U.S. tax.

From 1962 until the enactment of the Tax Reduction Act of 1975, foreign shipping income was not classified as Subpart F income. Therefore, in accordance with the generally applicable U.S. tax principle of deferral, the income attributable to the foreign operations of the effectively U.S.-controlled foreign flag (EUSC) fleet continued to be subject to U.S. tax only when and to the extent it was actually or constructively repatriated to the United States.[1/] In the Tax Reduction Act of 1975, Congress redesignated the foreign shipping income of a CFC as Subpart F income, but provided that such foreign shipping income would not be subject to the basic Subpart F current taxation rule if and to the extent such income was reinvested by the CFC in its foreign shipping operations. When the 1975 legislation was

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1/ "Effectively U.S.-controlled" foreign flag vessels are typically owned by foreign subsidiaries of U.S. corporations and are generally flagged under the laws of "open registry" countries that permit the United States to exercise control over the vessels in time of war or other national emergency.

enacted, the "reinvestment rule" was acknowledged to be necessary given the capital intensive nature of the foreign shipping business and the importance to the nation of a viable U.S.-owned maritime fleet.

In 1974, the House Ways and Means Committee in connection with an earlier proposal to significantly expand the scope of the Subpart F exception, stated:

> The interests of the United States are best served if we have a significant U.S.-owned maritime fleet. To assume and maintain this status, large amounts of capital are necessary. Further, many U.S. investors in foreign shipping corporations find their investments in such corporations 'locked in' by the corporation's financing arrangements and its need to retain amounts for repair and maintenance. If the present exclusions for shipping income were simply terminated and such income was treated as effectively distributed to U.S. shareholders, the foreign corporation's ability to meet these obligations would be jeopardized.

H.R. Rep. No. 1502, 93rd Cong., 2d Sess. 106 (1974).

Consequently, notwithstanding the redesignation of foreign shipping income as Subpart F income in 1975, for all practical purposes the general U.S. tax principle of deferral continued to apply to the foreign income of the CFC which was attributable to EUSC fleet operations where such income was reinvested in those foreign shipping operations.

The repeal of the reinvestment rule (and the resulting elimination of tax deferral) in the Tax Reform Act of 1986 was a fundamental tax law change that reversed more than half a century of U.S. tax policy. As explained below, the 1986 Act has had--and will continue to have--a severe adverse effect on the long-term viability of the EUSC fleet. Moreover, repeal does not conform to the tax policies of other key countries; it was not needed to protect the U.S. flag merchant marine fleet from deterioration; it is not in the national interest; and it is not sound tax policy.

III.

Severe Adverse Effects of the 1986 Act

The international shipping business is capital intensive and highly competitive. The capital intensive nature of the business requires an almost continual reinvestment of a high percentage of income to remain economically viable. The acceleration of the timing of U.S. taxation, resulting from repeal of the reinvestment rule, imposes a substantially higher cost of capital on the EUSC fleet (i.e., reinvestments must be financed for the first time with after-tax dollars). This is particularly significant because most "home countries" of the international flag vessels with which the EUSC fleet competes do not impose current taxes on the unrepatriated income of international shipping subsidiaries.

The following countries do not impose a comparable current tax on unrepatriated foreign shipping income: Greece, Hong Kong, the Netherlands, the Philippines, Taiwan, Italy, Korea, Denmark, and France. Under the tax laws of the United Kingdom, tax deferral is permitted with respect to 50 percent of unrepatriated foreign shipping income. While other countries (including Japan and Germany) have adopted tax regimes similar to Subpart F, their use of particular organizational structures, availability of tax

and non-tax concessions, or other arrangements significantly reduce the impact of such taxes.[2/] Significantly, approximately two years ago Canada liberalized the taxation of foreign shipping earnings of foreign corporations. This change was intended to attract to Canada the owners of Hong Kong-based shipping companies, and also to encourage those owners of foreign shipping operations that had relocated to other countries (and other shipping companies) to establish bases in Canada. (See Journal of Commerce, February 22, 1991.)

U.S. investors in the EUSC fleet effectively now pay a "premium" on investments in that fleet because those investments must be made with after-tax dollars, while a substantial portion of their foreign-controlled competitors still invest with pre-tax dollars. Over time, these premiums on investments in the EUSC fleet would require EUSC vessels to command higher charter rates than their competition in order to maintain overall rates of return that are comparable to those earned by their foreign-controlled competitors. To the extent such comparatively higher charter income cannot be obtained--and it will be virtually impossible to do so on a continual basis--the overall economic posture of the EUSC fleet will continue to be eroded. As a consequence of the 1986 legislation, owners of the EUSC fleet are being forced to adopt measures that will further erode the U.S. maritime industry.

The responses to the 1986 legislation include using joint ventures with foreign persons or other techniques to avoid the majority U.S. ownership that will trigger the application of the Subpart F exception, or relocating to another country, such as Canada. As these or other similar options are pursued in response to the 1986 legislation, there is an increased likelihood that a well-maintained EUSC fleet, both in terms of numbers of vessels and their state of repair, will be unavailable for requisition by the United States when the need arises. Indeed, these results have already begun to materialize. Few new tankers have been registered in the EUSC fleet since 1986, and majority ownership of some EUSC vessels has been transferred to foreign interests so that the vessel-owning foreign corporation will not be classified as a "controlled foreign corporation" for purposes of the Subpart F exception. (See Fairplay, Page 10, February 8, 1990.)

IV.

National Security Issues

The competitive viability of the EUSC fleet is a matter of national concern. The EUSC fleet has been deemed by the defense authorities to be a national security asset in times of war or other national emergency.

The National Sealift Policy, signed by the President on October 5, 1989, as National Security Directive 28, states in part:

> Sealift is essential both to executing this country's forward defense strategy and to maintaining a wartime economy. . . . The United States' national sealift objective is to ensure that sufficient military and civil maritime resources will be available to meet defense deployment, and essential economic requirements in support of our national security strategy.

2/ The information with respect to tax regimes of other countries is based in part on a November 1990 study conducted by Ernst & Young for OSG.

The experience with Desert Shield and Desert Storm vividly demonstrates the continued importance of our sealift capability even as the Cold War has ended. Restoration of the reinvestment rule for dual-flag operators will help ensure the viability of the EUSC fleet and advance the country's sealift policy.

V.

Restoration of the Shipping Reinvestment Rule

In light of the severe adverse consequences to the EUSC fleet of the 1986 repeal of the Subpart F reinvestment rule (and the importance of the EUSC fleet to the nation), Congress should restore the reinvestment rule for companies operating a qualified U.S. flag fleet.

Restoration of the reinvestment rule would not constitute a special tax break or insulate companies like ISC, OMI, and OSG from the rigors of international competition. The deferral of U.S. tax on unrepatriated earnings is the general norm of U.S. tax policy, as just reaffirmed by the Committee in adopting its budget reconciliation bill. The current inclusion rule of Subpart F is the exception to the historic principle of deferral. The income from the EUSC fleet, with its substantial required investment in tangible assets, differs from other types of income covered by the Subpart F exception. Restoration of the reinvestment rule would be consistent with the general scheme of U.S. taxation applicable to the active business operations of many other U.S. controlled foreign corporations. Restoration of the reinvestment rule also is consistent with the policy of the Clinton Administration to continue to permit deferral where foreign earnings are reinvested in an active foreign business.

Moreover, the reinvestment rule is necessary to promote cross-border tax equality between the U.S. owners of the EUSC fleet and many of the foreign owners of the foreign vessels with which the EUSC fleet competes. In short, from a tax policy perspective, restoration of the reinvestment rule would simply give the affected U.S. owners of foreign shipping corporations parallel treatment with the U.S. owners of many other types of controlled foreign corporations and with major foreign-based shipping competitors.

For the reasons set forth in this statement, Congress should reinstate the reinvestment rule for shipping income earned abroad by U.S. operators of dual flag fleets. Healthy EUSC operations can provide a source of financial strength to weather difficult market conditions by the U.S. merchant marine industry; and the health of both is critically important to the national interest.

Chairman RANGEL. Mr. McPherson.

STATEMENT OF DOUGLAS C. McPHERSON, CHAIRMAN, TAX COMMITTEE, AEROSPACE INDUSTRIES ASSOCIATION, AND STAFF VICE PRESIDENT FOR TAXES, GENERAL DYNAMICS CORP.

Mr. MCPHERSON. Yes, sir.

Mr. Chairman and members of the subcommittee, thank you for providing me the opportunity to appear today.

I would also like to thank Congressman Ben Cardin for introducing this proposal.

My name is Douglas McPherson, and I am staff vice president for taxes for General Dynamics Corp., and also chairman of the tax committee for the Aerospace Industries Association and am appearing on their behalf.

AIA is the trade association representing the Nation's manufacturers of commercial, military and business aircraft, helicopters, aircraft engines, missiles, spacecraft and related components and equipment.

Aerospace is one of the strongest exporting industries in the United States. It produced a $31 billion positive balance of trade in 1992. For every $1 billion of exports, 20,000 direct jobs are created or maintained and 17,000 indirect jobs are maintained. The industry is very labor intensive and relies on highly technical manufacturing skills.

My specific reason for being here is to request that section 923(a)(5) of the code be repealed. That section prevents aerospace and defense companies from competing as effectively as they could in foreign markets by reducing the benefits available to companies that sell military goods abroad.

This section is also inconsistent with the purposes of pending legislation to encourage economic recovery.

It might be helpful to briefly review the historical context in which section 923(a)(5) was enacted. As you know, the foreign sales corporation had a predecessor called the Domestic International Sales Corporation, and that was enacted in 1971 for the purpose of stimulating exports by granting a Federal income tax to promote U.S. firms engaging in exporting through domestic corporations. Until 1976 military property received the same benefit of the foreign sales corporation under the DISC corporation that other property did.

However, shortly after its inception, DISC provisions became the subject of a dispute between the United States and other signatories of GATT. In part as a response to these criticisms, Congress reduced the DISC benefits in the Tax Reform Act of 1976. In particular, DISC benefits for military products were cut back by half so that we now receive only one-half the benefits that every other property does.

In that regard, the House originally proposed to terminate all DISC benefits for military property unless they were to be used solely for nonmilitary purposes. The Senate, however, recommended that all DISC benefits be terminated for military property unless it was determined that the property was competitive with foreign manufactured property.

The joint committee finally reached a compromise and permitted the DISC benefits for military property to qualify for one-half of those benefits provided to all other property.

Of course, military property is broadly defined. However, the DISC dispute remained, particularly with the European Economic Community. And, in response to these concerns, Congress enacted the foreign sales corporation provisions in 1984. As a result, the 50 percent limit on military property was merely carried over and became section 923(a)(5).

The brief history of section 923(a)(5) indicates that the only reason the provision was enacted was that military products were not sold in a competitive market. This may have been true some 17 years ago, but it is clearly not today. U.S. aerospace companies and other defense companies compete directly with foreign manufacturers, many of which are subsidized by the governments or even compete directly with foreign governments themselves.

Three examples come quickly to mind: First, General Dynamics from the United States, GIAT industries from France, and the Krauss-Maffei—excuse my German interpretation—Wehrtechnik from Germany are competing for a $1.6 billion contract to build 200 tanks for the Swedish Army.

Second, McDonnell Douglas and Lockheed are competing with OFEMA, which is the French-owned industry in Russia, for the $800 million sale of jet fighters to Malaysia.

Third, U.S. and foreign competitors, including Russian and European firms, are vying to win a $3.7 billion helicopter contract from Britain and a $1 billion contract from the Netherlands.

These are mere examples and it should be strongly noted that the only military property sold, as we stated earlier, is that sanctioned by the U.S. State Department under the strict controls of the Arms Export Control Act.

As cuts are made in the U.S. defense budget, it is almost imperative that aerospace companies turn their attention to foreign markets. These export sales retain or increase employment in the United States.

As I previously indicated, $1 billion of export sales retains 20,000 direct jobs and 17,000 indirect jobs, retaining employees on a payroll causes them to pay taxes or at the very least keeps them off the unemployment rolls.

Also, by allocating certain costs to export sales, it reduces the cost from sales to the United States.

Finally, by permitting U.S. companies to supply military products to foreign countries, it helps us to retain an influence over the use of that equipment.

Further, the purchaser is more likely to rely on us for training, spare parts and upgrades.

In view of the above, the AIA recommends that Internal Revenue Code section 923(a)(5) be repealed.

I would like to thank you for the opportunity to appear and would be happy to answer any questions.

[The prepared statement follows:]

STATEMENT OF DOUGLAS C. MCPHERSON, GENERAL DYNAMICS CORP., ON BEHALF OF AEROSPACE INDUSTRIES ASSOCIATION BEFORE THE COMMITTEE ON WAYS & MEANS SUBCOMMITTEE ON SELECT REVENUE MEASURES JUNE 24, 1993

Introduction

Mr. Chairman and members of the subcommittee, thank you for providing me the opportunity to appear before you today.

My name is Douglas McPherson. I am Chairman of the AIA Tax Matters Committee and I am appearing today on behalf of the Aerospace Industries Association. AIA is the trade association representing the nations's manufacturers of commercial, military, and business aircraft, helicopter, aircraft engines, missiles, spacecraft, and related components and equipment.

The aeropace industry is one of the strongest exporting industries in the United States. It produced a $31 billion positive balance of trade in 1992, and is highly labor intensive and relies on highly technical manufacturing skills. For every $1 billion in aerospace sales, 20,000 direct and 17,000 indirect jobs are created.

I am here, to discuss a provision of the Internal Revenue Code that prevents aerospace companies from competing as effectively as they could in foreign markets. Specifically, I am referring to Internal Revenue Code section 923(a)(5), which reduces the benefits available to companies that sell military goods abroad to 50 percent of the benefits available to other exporters. This provision is inconsistent with the purposes of the pending legislation to encourage economic recovery and should be repealed.

History of Tax Law

Code section 923(a)(5) is part of the Foreign Sales Corporation or "FSC" provisions. To understand why Code section 923(a)(5) should be repealed, it is helpful to review briefly the historical context in which the FSC provisions were enacted. The genesis of the FSC was the Domestic International Sales Corporation or "DISC".

Congress enacted the DISC provisions in 1971 to stimulate exports and grant a Federal income tax deferral opportunity to United States firms engaged in exporting through domestic corporations. H.R. Rept. No. 533, 92d Cong., 1st Sess. 58 (1971). The advantage of exporting goods through a DISC was that a DISC was not subject to federal income tax on its earnings. Instead, the DISC's parent company was taxed each year on part of the DISC's earnings as if the parent company had received a dividend from the DISC. The DISC's remaining earnings were not taxed until actually distributed to the parent company. Until 1976, up to 50 percent of the DISC's annual export profits could be deferred in this manner, including profits from the sale of military products.

Almost since its inception, however, the DISC program was the subject of a dispute between the United States and other signatories of the General Agreement on Tariffs and Trade ("GATT"). Some countries contended that the DISC provisions essentially created an illegal export subsidy that violated the GATT.

In part as a response to these criticisms, Congress reduced DISC benefits in the Tax Reform Act of 1976. First, Congress changed the tax rules in such a way that less than 25 percent, rather than 50 percent, of a corporations earnings from exports

could be deferred from U.S. taxation. Second, DISC benefits for the sale of military products were cut back. The House originally proposed to terminate all DISC benefits for military sales, except if the products were to be used solely for nonmilitary purposes. The Senate recommended that all DISC benefits be terminated for military sales unless it was determined that the property was competitive with foreign-manufactured property.

The compromise reached by the Joint Committee was that DISC benefits would be terminated for 50 percent of military sales (whether or not competitive) made after October 2, 1975. H.R. Rept. 1515, 94th Cong, 2d Sess. 473 (1976). "Military property" for this purpose was defined very broadly to include any property listed in the munitions list published pursuant to the Military Security Act of 1954 and now contained in 22 U.S.C. S 2778. Military property includes any article that is inherently military in character without regard to its intended use such as, communications satellites and their components, launch vehicles, and many aircraft and their components.

The DISC dispute remained a serious irritant in U.S. trade relations with other countries, particularly the European Economic Community. Thus, the United States informed the GATT Council in October 1982, that it would propose to Congress legislation that would address the concerns of its trading partners over the DISC program. In March 1983, the Administration announced the general elements of an alternative to the DISC program. Legislation on the proposed alternative was introduced in Congress on August 4, 1983, to replace DISC's (with limited exceptions) with Foreign Sales Corporations. The FSC provisions were signed into law on July 18, 1984, as part of the Deficit Reduction Act of 1984.

The FSC provisions are similar to the DISC provisions in that they were designed to encourage exports by allowing exporters to exempt a percentage of export income from taxation. FSC benefits are provided for property manufactured or produced in the United States. The exemption on the sale of military goods, again, is half the amount otherwise allowed for other types of property. The legislative history makes it clear that this special rule for military property was simply a carryover from the DISC provisions. H. Rept. 861, 98th Cong., 2d Sess. 976 (1984).

Reasons for Change

To Summarize, this brief review of the history of Code section 923(a)(5) indicates that the only reason the provision was enacted was the premise that military products were not sold in a competitive market. While this may have been true 17 years ago when U.S. military technology was superior that of other countries, today the international market environment has changed drastically. U.S. aerospace companies compete directly with foreign manufacturers, many of which are subsidized by their governments, or even directly with foreign governments.

For example, on June 1, 1993, three companies submitted competitive bids for a $1.6 billion contract to build 200 tanks for the Swedish Army: General Dynamics from the U.S., GIAT Industries from France, and Krauss-Maffei Wehrtechnik from Germany. U.S. manufacturers McDonnell Douglas and General Dynamics are competing with OFEMA, the French owned defense industry as well as with the Russia for the $800 million sale of the jet fighters to Malaysia. U.S. and foreign competitors are also vying to win a $3.7 billion helicopter contract from Britain and a $1 billion helicopter contract from the Netherlands. As cuts are made to the U.S. defense budget, it becomes increasingly important for aerospace companies to turn their attention to foreign markets in order to

retain or increase employment in the U.S. and to preserve the skills and facilities necessary for a viable defense industrial base. Failure to retain this highly skilled work force would impair the industry's ability to develop the next generation of leading-edge weapon systems and could cause the U.S. to lose its technological preeminence.

The repeal of Code section 923(a)(5) would put aerospace companies in a more level playing field with other competitors, not only with respect to military products, but also with respect to commercial products. This is because companies that have developed skills and expertise by producing goods for military use are most likely to use that skill and expertise in commercial markets by developing new uses for military products or close derivatives from those products. Since the FSC provisions rely on a definition of military products that focuses upon the source of the product's development and its potential use, but not upon the actual intended use, almost all products currently produced by the aerospace industry will be subject to the 50 percent FSC limitation under current law even if these products or close derivatives are exported for strictly commercial purposes.

I want to emphasize at this point, that the repeal of section 923(a)(5) will not result in the loss of control by the U.S. Government over the export of property that has potential military application. Whether a product with potential military use could be exported would remain subject to the Arms Export Control Act 22 U.S.C. S 2778, 22 C.F.R. 120-128. The full FSC export incentive would be provided only on military-product exports approved by the State Department.

Moreover, when a U.S. company supplies military equipment, it usually continues to have an influence over the use of the equipment. For example, the purchaser may be dependent on the U.S. manufacturer for training, spare parts, and upgrades. Particularly in a developing country, the U.S. manufacturer may even be responsible for maintaining operations. If necessary, U.S. support quickly could be reduced in response to changing circumstances.

Recommendation

The AIA recommends that Internal Revenue Code section 923 (a)(5) be repealed.

I would like to thank you for the opportunity to appear before you today and stand ready to answer any questions.

Chairman RANGEL. Let me thank this panel. It has been very informative. And certainly Bill Jefferson and Congressman Cardin will be working very closely with the committee to see whether or not we can correct the inequities that exist in both of these areas of the law.

Thank you for taking time to be with us.

The fourth panel—and at this point is where we will insert the remarks of Congressman Matsui.

[The prepared statement follows:]

Robert T. Matsui

STATEMENT OF HONORABLE ROBERT T. MATSUI
MEMBER OF CONGRESS
STATE OF CALIFORNIA - DISTRICT 5
RE: INTEREST ALLOCATION

Mr. MATSUI: Mr. Speaker, today we are considering legislation to correct an unintended effect of the foreign tax credit limitation interest allocation rules enacted in the Tax Reform Act of 1986. This corrective legislation has been considered by Congress almost annually since the 1986 Act took effect; most recently, a proposal was included in the 1992 bipartisan tax bill H.R. 5270, the Foreign Income Tax Rationalization and Simplification Act of 1992, introduced by Chairman Rostenkowski and Rep. Gradison. Both the House and the Senate passed amendments substantially similar to the proposed amendment in 1987. However, the part of the 1987 bill that included this and other unrelated provisions was dropped in Conference as part of a procedural agreement to speed up enactment of the 1987 Act. It is past time for this problem with the interest allocation rules to be fixed.

BACKGROUND

In the 1986 Act, Congress adopted section 864(e) of the Internal Revenue Code, which generally provides that when allocating and apportioning deductions for purposes of computing foreign source taxable income, interest expense must be attributed to all the activities and property of a U.S. affiliated group, not simply the company that incurred the borrowing. Congress had concluded that the fungibility of money justified treating all affiliated companies as one economic unit for purposes of allocating interest expense. Under this provision, total U.S. affiliated group interest expense is allocated to foreign source income based on the ratio of foreign assets to total assets of the group. In enacting section 864(e), Congress specifically intended to prevent U.S. taxpayers from manipulating the location of borrowing within the affiliated group to a company without foreign source income, thereby reducing foreign source interest expense and increasing the foreign tax credit limitation.

In enacting section 864(e), Congress created an exception to the consolidated group rule for certain regulated financial institutions. This exception, found in section 864(e)(5), was adopted to avoid the distortion that otherwise would occur when a single affiliated group includes both nonfinancial businesses and banking businesses. Nonfinancial businesses typically are less highly leveraged than financial businesses, because the marketplace will accept much greater leverage for a financial entity with liquid assets. Without such an exception, the allocation of interest expense of the U.S. regulated financial institution to nonfinancial enterprises would distort the taxpayer's foreign tax credit limitation.

For example, assume that a U.S. affiliated group consisted of a bank and a manufacturing business. Assume the bank operates wholly within the U.S., with $200 of assets, $30 of gross income and $20 of interest expense. The manufacturing business has $100 of assets in the U.S. and $100 of assets outside the U.S. The manufacturing business earns $20 of gross income, with $4 of interest expense. If the general rule for allocating interest expense applied to this group -- that is, if Congress had failed to enact the exception in section 864(e)(5) -- the total $24 of interest expense of the group would have been allocated pro rata to the assets of the group. The manufacturing business would have been allocated $12 of interest cost, and half of that cost ($6) would have reduced foreign source taxable income from the manufacturing business even though that amount of interest expense exceeded the <u>total</u> interest expense economically attributable to the manufacturing business.

This precise problem exists today for any affiliated group that includes a financial business that is not a regulated bank, and therefore does not qualify for the section 864(e)(5) exception. In such a case, the interest expense of the highly leveraged financial business is allocated and apportioned in significant part to the lightly leveraged manufacturing business. The result is a distortion in determining the U.S. source taxable income and the foreign source taxable income of the businesses.

PROPOSAL

The proposal being considered today, which is identical to the provision in H.R. 5270 with two clarifications, would provide that an affiliated group that includes a corporation predominantly engaged in financial services operations would treat the financial services corporation separately for purposes of the interest allocation rules. The proposal includes anti-abuse rules to ensure that the financial business and the nonfinancial business are operated separately and this rule is not used to undermine the Congressional intent behind the 1986 Act.

As I stated before, this provision was included in H.R. 5270, introduced in 1997 by Chairman Rostenkowski and Rep. Gradison. The only differences between that proposal and the one being discussed today are two changes to clarify the operation of the provision. First, this proposal clarifies that the term "related persons" does not encompass persons who purchase goods from the affiliated group but do not obtain financing for those same goods. Second, the proposal states that the anti-abuse rule for certain loans between financial members and nonfinancial members of the group does not apply to loans that bear interest at a rate at least equal to the applicable Federal

rate as determined under Section 1274(d) of the Code, a provision designed to approximate a market interest rate. This clarification is necessary to prevent a double allocation of interest expense.

I understand the purpose of the interest allocation rules in section 864(e) that Congress enacted as part of the 1986 Act, and I support the intent of those rules. It is my hope however, that we can better address the situation where an affiliated group of companies includes both highly leveraged financial business and lightly leveraged nonfinancial companies so as not to distort the computation of net income of both the financial businesses and the nonfinancial businesses.

Chairman RANGEL. What I would suggest is that we will recess until one of the members returns from the vote and then we will assume with the fourth panel.

That would be Tom Remar of WMX Technology & Services; Bartow Shaw, Forest Industries Council on Taxation, chairman; Virginia Lazenby, Independent Petroleum Association; Mary Beth Zimmerman, Alliance to Save Energy; and Scott Sklar from Solar Energy Industries.

So when one of the members returns from this vote we will resume the hearing.

[Recess].

Mr. PAYNE [presiding]. I would like to welcome the fourth panel. I understand you have already been introduced, and so Mr. Remar, if you would proceed, all of your statements will be put into the record.

STATEMENT OF TOM REMAR, GROUP DIRECTOR FOR ENERGY SYSTEMS, WMX TECHNOLOGY & SERVICES, OAK BROOK, ILL.

Mr. REMAR. Very good, sir. Thank you very much.

My name is Tom Remar. I am the director of energy systems for one of the Waste Management Inc.'s operating groups.

My job for Waste Management is to build and operate power plants, the type of power plants that pull naturally occurring landfill gas from landfills and use it as fuel to power turbines and engines to generate electricity. It is an interesting, challenging job, and we have developed the technology to the point where our plants operate very reliably on this unusual fuel that is landfill gas.

These plants can operate for decades. We are now building a plant in Des Moines, Iowa, that we plan to operate for 50 years.

I have found that the best way to manage these plants is to implement systems that will enable them to operate reliably every day, year after year. The way to do that is to give them to the young people that operate these facilities, literally give them the plants.

I may develop these projects and get them built, but these operating facilities belong to them. They make the operating decisions, the technical decisions, the business decisions. They operate the business, and this sytem has worked out very well.

There is only one thing that is missing in this approach, and it causes us some very real headaches. It is described in the prepared remarks that we have previously distributed to you. It is called the third party sale rule at section 29, IRS Tax Code.

The operating-type people can run these turbines and engines. They can maintain the health and productivity of this fuel-producing well field. They can feed electricity into the utility grids. There are many things that are necessary for running a real time power plant business, except they cannot sell the electricity.

The final step to close this loop, to be able to run this as a real business, is to get paid for what you are doing. The third party sale rule requires that the power plant belong to an unrelated third party, and you as an operator become a contract operator for this third party.

What we are simply asking is that the IRS Code be changed to simply recognize this reality. There should be no tax revenue impact on this at all. We are not asking for any more money. We are simply asking that the needless red tape go away so we can do the job that we are doing today a little bit better.

What we have done is prepare some testimony that has been previously given to you, and if you have any questions on that or any remarks I have made, I would be more than happy to address them at this point in time.

Mr. PAYNE. Thank you very much.

[The prepared statement follows:]

STATEMENT OF
TOM REMAR, GROUP DIRECTOR -- ENERGY SYSTEMS
WASTE MANAGEMENT, INC. -- MIDWEST
OAKBROOK, ILLINOIS

HEARING ON MISCELLANEOUS REVENUE ISSUES

SUBCOMMITTEE ON SELECT REVENUE MEASURES
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

JUNE 24, 1993

Mr. Chairman, I appreciate the opportunity to testify today. I am the Group Director for Energy Systems for Waste Management.

Most people know our company for our expertise in handling municipal wastes and other types of wastes and pollutants. But we are also an energy company. We have developed the expertise to capture and use the gas that is produced from the biomass -- which is decomposing organic material -- in landfills. Our company is the leading producer of landfill gas in the country, with 26 facilities operating around the country and a number of other facilities planned.

The capture of gas from landfills contributes to the country's energy supplies, while also serving the environmental purpose of preventing the gas from seeping into the atmosphere. The EPA has long promoted, and continues to promote, the environmental benefits of recovering landfill gas.

The sale of gas produced from biomass qualifies for the federal tax credit for nonconventional fuels -- the section 29 credit. To encourage the capture and use of landfill gas, Congress extended the credit for that fuel, as well as for several other fuels, in last year's Energy Policy Act. The credit will apply to gas produced from landfill gas facilities that are put in service through 1996.

The reason I am here today is to discuss one of the minor requirements of section 29 which, we believe, creates an unnecessary administrative burden for companies like ours. Section 29 requires companies to sell nonconventional fuel to an unrelated person to qualify for the credit. In other words, under current law, companies that produce nonconventional fuel cannot claim the credit if they use the fuel themselves; they have to sell the fuel to someone else.

For most applications of section 29, this rule doesn't cause a problem. Most of the gas that qualifies for section 29 comes from standard wells drilled in the ground (in formations like Devonian shale, coal seams, and tight sands). In those cases, the owner of the well simply enters the gas into a pipeline, where the gas is sold to an unrelated person in the ordinary course of business.

But the rule does create a problem with landfill gas. The reason is this: landfill gas is best used on site to generate electricity. Landfill gas normally is not sold into a pipeline.

Why is this? For one thing, there may not <u>be</u> a pipeline near a landfill gas facility. You can't sell gas into a pipeline unless there is a pipeline. By contrast, when energy companies develop a typical natural gas field, the installation of a pipeline gathering system is a standard part of the development; the large gas volumes warrant that expense. The typical solitary, isolated, landfill, by contrast, does not justify the expense of constructing a pipeline of any significant length.

In addition, the gas from a landfill typically has a lower Btu content than natural gas. So even if there is a pipeline in the area, the owner of the gas cannot sell the gas into it without "conditioning" the gas to raise its Btu content -- which is generally too expensive to consider.

In a nutshell, when our company produces landfill gas we have to identify a local use for it. Sometimes, we can sell the gas to a nearby factory for use as boiler fuel. That use of the gas does not run afoul of the unrelated person rule, but it is a relatively rare situation; there has to be a nearby factory that wants the gas. More commonly, we use the gas on site to generate electricity. That means we have to install a generating facility on the landfill site.

It is the use of landfill gas on site to generate electricity that causes the problem I am addressing today. In the absence of the unrelated person sale rule, our procedure would simply be to purchase generating equipment, install it on the landfill site, and use it to generate electricity with the gas that we produce. That would be straightforward. But that would run afoul of the unrelated person sale rule and we would lose the section 29 credit. As a practical matter, without the credit, few landfill gas projects would be economically feasible. (Either landfill gas would be uncollected or, if collected, would be flared off by the landfill operator).

To avoid losing the credit, we are forced to fashion an arrangement that makes no business sense, but that complies with the unrelated person sale rule. Specifically, we have to arrange for an unrelated person to own the generating facilities on our landfill site. We sell the gas to that unrelated person and thereby qualify for the credit. In our actual projects, the unrelated person is a joint venture in which our company has a non-controlling interest. We employ this arrangement in every project in which we use the gas to generate power. This is the standard practice in the industry for companies that are using landfill gas instead of flaring it off and wasting it.

For us, it is just a needless administrative burden to have to bring a third party into our projects. There is no savings at all to the Treasury -- we get the same tax credit whether or not we have a third party. The only effect of the requirement is to create red tape.

To avoid the red tape, we are suggesting that Congress amend section 29 to allow companies to dispense with the unrelated person sale requirement if they produce landfill gas (or synthetic gas from coal -- which also has the problem) and use the gas on site to generate power for sale to unrelated persons. Companies that produce the gas would measure it with standard metering methods -- just as they do when they sell the gas to an unrelated person. The credit would be the same as if the gas were sold.

We have attempted to determine what the purpose of the unrelated person sale rule was when section 29 was enacted in 1980. The legislative history does not reveal the purpose. Some speculate that the purpose was to provide the IRS with an audit trail of the amount of gas that qualifies for the credit. If that was the case, then our suggestion that the gas be required to be metered should fill the same purpose.

Furthermore, the requirement that the electricity be sold to an unrelated person would mean that the IRS could, as an audit check, compare the amount of electricity produced with the amount of gas produced. Variations in the ratio between the two amounts could suggest a problem that the IRS should examine.

It is noteworthy that the new section 45 tax credit -- which applies to the sale of electricity produced from biomass --

contains no rule requiring the biomass to be sold to an unrelated person. Just as we are suggesting, the only requirement is that the electricity be sold to an unrelated person. The difference is that the section 45 credit applies to the electricity and not to the fuel. If necessary, it would probably be possible to turn the section 29 credit into an electricity credit on a case-by-case basis.

We understand that the Joint Tax Committee staff has estimated that our proposed amendment would lose a modest amount of revenue over the next five years. As I have explained, for our company, the amendment will not result in any tax saving. Tax saving is not our goal. We will be working with the Joint Tax Committee staff to see what can be done to shape the amendment to ensure that the revenue loss is as close to zero as possible.

Lastly, Mr. Chairman, as indicated above, the unrelated person sale rule is an issue not only with respect to landfill gas, but also with respect to coal gasification -- another activity that qualifies under section 29. Like landfill gas, synthetic gas from coal normally has a lower Btu content than natural gas; its best use, too, is to generate power on site. Our company is working closely with companies involved in coal gasification on this amendment. Like our company, those companies are not seeking a tax reduction, but are seeking merely to avoid the unnecessary red tape of structuring a coal gasification project as a sale of gas between unrelated persons.

Once again, Mr. Chairman, I appreciate the opportunity to appear today. I would be pleased to answer any questions that the subcommittee may have on this issue.

Mr. PAYNE. Our next witness is with the Forest Industries Council on Taxation, Mr. Shaw.

STATEMENT OF BARTOW S. SHAW, JR., CHAIRMAN, FOREST INDUSTRIES COUNCIL ON TAXATION

Mr. SHAW. Mr. Chairman, thank you very much.

My name is Bartow Shaw. I am president of the forestry firm of Shaw, McLeod, Belser & Hurlbutt, in Sumter, S.C.

I am also the chairman of the Forest Industries Council on Taxation, the national trade association which represents the forest industry and the nonindustrial timberland owners on all Federal forestry tax issues.

In addition, I am a member of the board of directors of the American Forest & Paper Association, the national trade association of the paper and forestry industry.

I wish to thank you for giving me the opportunity to testify before the subcommittee today on legislation which is vitally important to tree growers throughout the Nation, H.R. 960, the Reforestation Tax Act of 1993, referred to as the RTA.

I submit this statement on behalf of the 32 organizations endorsing the RTA. These organizations are listed on our written report, and they include the American Forests & Paper Association, the Forest Farmers Association in Atlanta, the Southeastern Lumber Manufacturing Association, the Wilderness Society, the Natural Resources Defense Counsel, the Oregon Small Wood Landowners and numerous State and regional forestry organizations also support this bill.

The Tax Reform Act of 1986 eliminated the existing differential for capital gains, creating an economic hardship for timber growers. While the lower regular rates of tax reform have proven beneficial, the loss of a capital gains differential is having an adverse effect on an economically fragile resource. Without a capital gains differential, the already constrained timber resource will not attract sufficient capital to keep up with the increasing demand.

Timber growing requires heavy front-end expenditures, long-term carrying charges, high risks of weather, disease, insects and fire, uninsurable for all practical purposes.

Rates of return are historically low compared to alternative investments. With capital literally locked in the ground during the growing cycle, timber growing does not enjoy market liquidity as trees cannot normally be economically harvested before maturity.

America's forests are the most productive forest lands in the world because of the huge timber growing investments that have been made to increase productivity. Without a capital gains differential, investments in growing long-term timber crops are declining. And for each year there is an inadequate reforestation and less effective timber management, that year's lost planting is lost forever. A tree cannot be planted retroactively.

The consequences of the decreased flow of capital investment in timber is likely to mean that lands currently owned will be less well-managed, forest research will decline, pressure will mount to harvest forests prior to the economic maturity, planting activity will decrease and marginal land will go out of production. In some

cases, timber land will be replaced with agricultural crops or real estate developments.

Forest landowners from large industrial to small private landowners are located in nearly every section of the Nation. They are almost 7 million strong and own 350 million acres of woodlands, encompassing more than 72 percent of all commercial forests.

Original investment decisions by those landowners were based on the capital gains treatment of their income, a provision in the code literally for decades.

In 1986, the rug was pulled out unexpectedly for many timber growers ready to harvest that had made long-term investments. This imposed a higher tax at ordinary rates and without the possibility of averaging their income even though economic circumstances forced them to receive in some cases a lifetime's gain on their timber in 1 year. Now many landowners are rethinking plans to reforest which could cause severe shortages.

In order to discourage investments in so-called abusive tax shelters, Congress enacted passive activity loss rules, section 469 of the Internal Revenue Code, as part of the Tax Reform Act of 1986. Under these rules, if a taxpayer owning an interest in a trade or business does not materially participate in the business, limitations are imposed on a current deductibility of the business losses.

Under IRS regulations, the tests which generally apply to small tree growers requires that the taxpayer devote at least 500 hours per year to this tree growing business. The other tests generally applicable to tree farmers requires a minimum of 100 hours of personal work before the taxpayer can hope to qualify and then only if other appropriate facts exist.

A typical small timber owner normally performs all of the tasks and makes all of the decisions necessary to manage a tree growing business while bearing all of the risks of loss.

Managing a small tree farm typically does not require 500 hours per year of the owner's time and in many cases not even 100 hours per year. Thus, many owners simply cannot satisfy the artificial hourly requirements and become subject to the passive loss rule. The unanticipated application of the passive activity loss antitax shelter rules to small tree growers has proven to be a deterrent to efficient timber practices, and owners are reluctant to make what is tantamount to annual nondeductible capital expenditures.

There is no reason to apply the antitax shelter rules to small tree farmers. Timber growing is not a tax shelter. All expenditures represent hard currency outlays. Leveraging is unavailable because of the substantial amount of uninsurable risks. There are no current depreciation deductions.

We believe some narrow, reasonable tax incentives are needed to encourage more active management of existing private timberlands and the growth of the private timber base.

The major provisions of the Reforestation Tax Act are:

Number one, partial inflation adjustment. Upon the sale of timber, the gain would be reduced by 3 percent for every year the timber was held. This provision is restricted so that the reduction in stumpage value cannot reduce the gain by more than 50 percent.

The second provision is the passive loss rule. This section clarifies when an individual owner would be able to deduct normal op-

erating expenses pertaining to management of their tree lots. It was included in H.R. 11 which passed the House and Senate last year.

Number three was the reforestation tax credit. This provision simply updates existing laws by doubling the expenditure limit from $10,000 to $20,000 and indexing this amount for inflation.

And, number four, the reforestation amortization. This provision also updates existing law by doubling the limit to $20,000 and indexing it to inflation and reducing the 7-year amortization period to 5 years.

The original bill was estimated to have a revenue loss of $1.15 billion over 5 years. In order to reduce this revenue loss and to insure that Federal dollars that now promote log exports are used to encourage continued reforestation on private lands, we propose the following modifications to our bill:

Number one, inflation adjustment. The maximum qualified percentage would be lowered from 50 to 30 percent. The adjustment would be allowed at a rate of 2 percent for each year the asset is held rather than 3 percent. Thus, the maximum adjustment would require a 15-year holding period.

Minimum holding period is the second point. The taxpayer would be required to hold the asset for a minimum of 5 years before any inflation adjustment would be allowed.

And, third, the elimination of tax benefits for log exports. Provisions from Congressman Pete Stark's bill, H.R. 1542, would be added to our bill. These provisions repeal tax incentives for exports of raw softwood logs.

In this regard, we note that the Senate version of the reconciliation bill, H.R. 2141, contains the companion measure to the Stark bill, S. 894. We strenuously oppose the use of this revenue for deficit reduction.

The revenue from S. 894 is being extracted from the forest products industry. It should be used to produce more jobs and increase domestic timber production. In effect, it should be used to offset revenue loss of the RTA that we have addressed here today, a bill which is designed to encourage increased reforestation, thereby promoting an increase in domestic jobs within the timber industry.

These revisions will also accomplish one of the goals set forth by President Clinton at the Forest Summit where he stated he would propose the elimination of current tax subsidies for log exports in order to promote domestic production, increase the domestic timber supply and increase domestic jobs. The revised Reforestation Tax Act satisfies the President's objectives.

We commend Congressmen Mike Kopetski and Ron Wyden for developing and introducing this very important piece of legislation, the Reforestation Tax Act of 1993, and for their efforts in championing the causes of tree farmers throughout the Nation.

Mr. Chairman, this concludes my remarks. I would be glad to answer any questions. Thank you very much for your time.

[The prepared statement and attachment follow:]

STATEMENT OF BARTOW S. SHAW, JR.

CHAIRMAN

FOREST INDUSTRIES COUNCIL ON TAXATION

BEFORE THE

SUBCOMMITTEE ON SELECT REVENUE MEASURES

COMMITTEE ON WAYS AND MEANS

UNITED STATES HOUSE OF REPRESENTATIVES

JUNE 24, 1993

Mr. Chairman, my name is Bartow S. Shaw, Jr. I am President of the firm of Shaw, McLeod, Belser & Hurlbutt of Sumter, South Carolina. I am also the Chairman of the Forest Industries Council on Taxation, the national trade association which represents the forestry industry on all federal forestry tax issues. In addition, I am a member of the Board of Directors of the American Forest and Paper Association, the national trade association of the paper and forestry industry. I wish to thank you for providing me the opportunity to testify before the Subcommittee today on legislation which is vitally important to tree growers throughout the nation, H.R. 960, the Reforestation Tax Act of 1993 (the "RTA"). I submit this statement on behalf of the thirty-two organizations listed on the attached page which have endorsed the RTA.

CAPITAL GAINS AND TIMBER

* **A substantial capital gains tax differential is essential for long-term timber growing investments, and is critical to attracting sufficient capital to ensure long-term supply.**

The Tax reform Act of 1986 eliminated the existing differential for capital gains, creating an economic hardship for timber growers. While the lower regular rates of tax reform have proven beneficial, the loss of a capital gains differential is having an adverse effect on an already economically fragile resource. Without a capital gains differential, the already constrained timber resource will not attract sufficient capital to keep up with the increasing demand.

* **A capital gains differential is an economically sound method for providing fair taxation of timber income.**

Timber growing requires heavy front-end expenditures, long-term carrying charges, high risks of weather, disease, insects and fire -- all uninsurable. Rates of return are historically low compared to alternative investments, with capital literally locked in the ground during the growing cycle. Timber growing does not enjoy market liquidity as trees cannot normally be economically harvested before maturity.

* **The capital gains provisions of the Tax Code proved to be an effective mechanism for increased production and improved forest management.**

Since its enactment in 1944, capital gains treatment for timber dispositions has resulted in impressive gains in planting and productivity. Today, in spite of increased harvests to meet consumer needs, there is actually more growing stock than in 1944. Capital gains played an important role in achieving that result.

America's forests are the most productive forest lands in

the world because of the huge timber growing investments that have been made to increase productivity. Without a capital gains differential, investments in growing long-term timber crops are declining. And for every year that there is inadequate reforestation and less effective timber management, that year's lost planting is lost forever -- a tree cannot be planted retroactively.

* **The growing and management of timber crops is a unique economic enterprise.**

Congress long ago saw the need to provide fair and equitable taxation to those who had the enterprise and vision to invest in the long-term potential, but inherently uncertain, gains from timber growing. It takes 30 to 75 years to grow timber used in the manufacture of lumber and plywood, and 15 to 30 years to grow timber used for pulpwood. That is why federal tax treatment for timber growing is particularly important for forest landowners who furnish the nation's timber resource.

* **There are a multitude of benefits provided to society by sound forest management practices -- practices enhanced by a climate of fair taxation as owners manage for optimum productivity.**

These practices serve to significantly enhance the overall environmental quality of our forests and their surrounding communities. Our professionally managed forests provide vital wildlife enhancement, water quality, a hedge for soil erosion, provide for recreational needs and create aesthetic beauty.

In fact, we are now learning more fully the critical role being played by reforestation in the effort to combat the so-called "greenhouse effect", while at the same time the land is growing trees for future wood supply. Landowners are committed to sound environmental stewardship of our forest land. But without the corresponding fair economic environment necessary to grow trees over the long run, represented in part by capital gains, the potential for deterioration in those management practices increases.

* **The economic impact of the loss of capital gains is severe now, but the long-term negative consequences will be even greater.**

The consequences of the decreased flow of capital investment in timber is likely to mean that lands currently owned will be less well managed, forest research will decline, pressure will mount to harvest forests prior to economic maturity, planting activity will decrease and marginal land will go out of production. In some cases, timberland will be replaced with annual agricultural crops or real estate developments.

All of these fallouts will result in fewer jobs and hurt many small, rural communities. And, of course, a more limited timber supply will lead to higher prices and significantly greater pressure to harvest timber from public lands at a time when more public lands are already being withdrawn from harvesting for a variety of reasons.

Forest landowners -- from large industrial to small private -- are located in nearly every section of the nation. They are almost seven million strong and own 350 million acres of woodlands, encompassing more than 72 percent of all commercial forests. Original investment decisions by those landowners were based on the capital gains treatment of their income, a provision in the Code literally for decades. In 1986, the rug was pulled out unexpectedly for many timber growers ready to harvest, imposing a higher tax at ordinary rates -- and without the possibility of averaging their income even though economic

circumstances forced them to receive, in some cases, a lifetime's gain on their timber in one year. Now, many landowners are rethinking plans to reforest which could cause severe shortages in the future.

MODIFICATION TO THE MATERIAL PARTICIPATION TESTS FOR SMALL TREE GROWERS UNDER PASSIVE ACTIVITY LOSS RULES

In order to discourage investments in alleged "abusive" tax shelters, Congress enacted passive activity loss rules (Sec.469, I.R.C.) as part of the Tax Reform Act of 1986. Under these rules, if a taxpayer, owning an interest in a trade or business, does not "materially participate" in the business, limitations are imposed on the current deductibility of his or her share of the business losses.

The losses can only be currently offset against income from other trades or businesses in which the taxpayer also does not materially participate. However, the losses may eventually be offset against any gain realized when the taxpayer disposes of his or her entire interest in the business.

IRS regulations provide that taxpayers are treated as material participants if they can meet one of several tests. Each test requires that the taxpayer must devote a minimum number of hours to the business in order to qualify. The test which generally applies to small tree growers requires that the taxpayer devote at least 500 hours per year to the tree growing business. The other test generally applicable to tree farmers requires a minimum of 100 hours of personal work before the taxpayer can even hope to qualify and then only if other "appropriate facts and circumstances" are present.

Should tree growers be required to work 500 hours or 100 hours or any other arbitrarily determined number of hours to qualify as a "material participant".

A typical small timber owner normally performs all of the tasks and makes all of the decisions necessary to manage the tree-growing business while bearing all the risks of loss. Yet, managing a small tree farm typically does not require 500 hours per year of the owner's time, and in many cases, not even 100 hours per year. Thus, many owners simply cannot satisfy the artificial hourly requirements and become subject to the passive loss rules.

Efficient timber management requires periodic expenditures notwithstanding the fact that there may be 15 to 25 or even 50 year intervals between tree harvests. Moreover, even in years when no direct management expenditures are incurred, indirect expenses such as property tax payments are required. With little or no income in the years between harvests, small timber owners' expenditures become passive losses deductible many, many years in the future, severely impacting the owners'already modest cash flow.

The unanticipated application of the passive activity loss anti-tax shelter rules to small tree growers has proven to be a deterrent to efficient timber practices in that owners are reluctant to make what is tantamount to annual nondeductible capital expenditures. There is no reason to apply the anti-tax shelter rules to small tree farmers. Timber growing is not a tax shelter. All expenditures represent hard currency outlays. Leveraging is unavailable because of the substantial amount of uninsurable risks. And, there are no current depreciation deductions.

We must create a self-sustaining resource of trees to ensure

raw materials for timber workers' jobs as well as provide a continuing supply of reasonably affordable building materials for consumers. And it is increasingly obvious that our most reliable source could be the millions of acres of privately owned forest lands. The RTA introduced on February 19, 1993, will create reasonable tax incentives to increase reforestation and enhance timber management on private land. The legislation currently has 37 co-sponsors.

Timber farming is a long-term, high-risk venture, subject to the vicissitudes of disease, fire and a highly unpredictable marketplace. In some regions, tree farmers must wait 75 years from the planting of a seedling to the harvest of a mature tree. These landowners suffered a severe setback with the 1986 Tax Reform Act in the loss of the capital gains differential and passive loss rule changes which, in many cases, ended their ability to deduct normal business expenses.

We believe some narrow, reasonable tax incentives are needed to encourage more active management of existing private timberlands, and the growth of the private timber base.

THE REFORESTATION TAX ACT OF 1993

The major provisions of the RTA as originally introduced are:

1. PARTIAL INFLATION ADJUSTMENT:

Upon the sale of timber, for purposes of determining Section 631 gain, the gain would be reduced by three percent for every year the timber was held. This provision is restricted so that the reduction in stumpage value cannot reduce the gain by more than 50 percent. While this provision would not compensate fully for the negative tax impact of inflation, it would provide a significant incentive for those tree farmers who hold their investment for a long period of time.

2. PASSIVE LOSS RULES:

This provision clarifies when individual owners, or principals in partnerships, would be able to deduct normal operating expenses pertaining to management of their treelots. This would be achieved through a new set of "material participation" criteria correcting what we believe to be an unintended result of the 1986 reforms. This provision was included in H.R. 11 which passed both Houses of Congress last year.

3. REFORESTATION TAX CREDIT:

This provision simply updates existing laws by doubling the expenditure limit from $10,000 to $20,000 and indexing this amount for inflation.

4. REFORESTATION AMORTIZATION:

This provision also updates existing law by doubling the limit to $20,000, indexing it to inflation and reducing the seven-year amortization period to five years.

The original bill was estimated to have a revenue loss of $1.15 billion over five years. In order to reduce the bill's revenue loss and to insure that federal dollars that now promote log exports are used to encourage continued reforestation of private lands, we propose the following modifications to our original bill:

1. INFLATION ADJUSTMENT:

The maximum qualified percentage would be lowered from 50 percent to 30 percent. The adjustment would be allowed at a rate of 2 percent for each year the asset is held. Thus, the maximum adjustment would require a 15 year holding period.

2. MINIMUM HOLDING PERIOD:

A taxpayer would be required to hold the asset for a minimum of 5 years before any inflation adjustment would be allowed. However, the taxpayer would be accruing a 2 percent per year adjustment during this minimum holding period.

3. ELIMINATION OF TAX BENEFITS FOR LOG EXPORTS:

Provisions from Congressman Pete Stark's, H.R. 1542, would be added to our bill. These provisions repeal the availabilty of foreign sales corporations and domestic international sales corporations for exports of raw softwood logs as well as change the title passage and deferral of foreign source income rules for log exports. In this regard, we note that the Senate version of the Reconciliation Bill, H.R. 2141, contains the provisions of the companion measure to the Stark bill, S.894. We strenuously oppose the use of this revenue for deficit reduction. The revenue from S. 894 is being extracted from the forest products industry. It should be used to produce more jobs and increase domestic timber production. In effect, it should be used to offset the revenue loss of the RTA, a bill which is designed to encourage increased reforestation, thereby promoting an increase in domestic jobs within the timber industry.

According to the Joint Committee on Taxation, the reduction in the maximum qualified percentage from 50 to 30 percent and the addition of the provisions from H.R. 1542 will reduce the revenue loss of the RTA to $434 million over five years. We believe the additional modifications suggested herein will result in a revenue neutral bill.

This bill is a key element in maintaining private forest land in a productive posture. Fair tax treatment will help insure that timber growers do not convert their lands to other, non-forest uses.

The revisions to our legislation would also accomplish one of the goals set forth by President Clinton at the April Forest Summit. The President indicated that he would propose the elimination of current tax subsidies for log exports in order to promote domestic production, increase the domestice timber supply and increase domestic jobs. The revised Reforestation Tax Act satisfies the President's objectives.

We commend Congressmen Mike Kopetski (D-OR) and Ron Wyden (D-OR) for developing and introducing this very important piece of legislation, the Reforestation Tax Act of 1993, and for their efforts in championing the cause of tree farmers throughout the nation.

LIST OF COSPONSORING ORGANIZATIONS FOR RTA

American Forest and Paper Association
Forest Industries Council on Taxation
Forest Farmers Association
Southern Forest Products Association
Southeastern Lumber Manufacturers Association
Maine Forest Products Council
Small Woodland Owners Association of Maine
Arkansas Forestry Asssociation
Southern State Foresters
Georgia Forestry Association
Louisiana Forestry Association
North Carolina Forestry Associaiton
South Carolina Forestry Association
Mississippi Forestry Association
Texas Forestry Association
Virginia Forestry Association
American Pulpwood Association
National Association of State Foresters
Hardwood Manufacturing Association
National Hardwood Lumber Association
Hardwood Research Council
Hardwood Forest Foundation
Alabama Forestry Commission
Stewards of Family Farms, Ranches and Forests
The Wilderness Society
The National Woodland Owners Association
The Oregon Small Woodlands Association
The Washington Farm Forestry Association
1,000 Friends of Oregon
The Idaho Forest Owners Association
The Forest Landowners of California
The Natural Resources Defense Council

Total: 32

Chairman RANGEL [presiding]. Ms. Lazenby.

STATEMENT OF VIRGINIA LAZENBY, VICE CHAIR OF THE CRUDE OIL POLICY COMMITTEE, INDEPENDENT PETROLEUM ASSOCIATION OF AMERICA; CHAIRMAN, BRETAGNE CORP., NASHVILLE, TENN.; AND PRESIDENT, NATIONAL STRIPPER WELL ASSOCIATION

Ms. LAZENBY. Yes. Good afternoon.

My name is Virginia Lazenby. I am here on behalf of independent oil and gas producers, the Independent Petroleum Association of America and as president of the National Stripper Well Association. I want to encourage Congress to make tax law changes that will preserve and enhance production from marginal wells and that will stimulate investments in new drilling.

H.R. 1024 and the proposal we have outlined in our written testimony will achieve those goals. There is no question about whether we need to stimulate the domestic oil and natural gas industry. The Department of Energy is coordinating a multiagency task force to arrive at options for doing just that, stimulating the domestic industry.

What independent producers have told the Energy Department and our testimony today is that the Tax Code is the most efficient and effective way to preserve and expand the domestic oil and natural gas industry.

Let's look at marginal oil and gas production in this country. Marginal wells produce $7 billion a year in revenue, represent more than 15 percent of domestic oil production and provide more than 100,000 jobs. They are a resource worth preserving, but government action is needed.

Oil production is at its lowest level since 1960. No wonder the trade deficit is dominated by oil imports. Fifty-three percent of the 1992 trade deficit, some $45 billion, was oil imports. The loss of marginal production would add $7 billion annually to the trade deficit. In April alone U.S. oil production fell 5 percent or 360,000 barrels per day.

U.S. production is 6.9 million barrels per day. Imports are 8.6 million barrels per day. The increase in imports, 25 percent over last year for oil and 50 percent over last year for gas, is not from increased demand but from deteriorating domestic supplies. Those deteriorating domestic supplies are marginal producers going out of business.

H.R. 1024 and the proposal we have put before you both will enhance production of oil and gas from marginal properties by helping marginal producers raise capital.

Why do marginal producers need help raising capital? It is an understatement to say that the capital markets are not wild about small U.S. oil and gas producers. Price uncertainty and increasing regulatory costs simply make investment in marginal production too risky for most investors, and at current prices internally generated cash flow is insufficient to fund replacements and additions to reserves.

Oil and gas are declining assets. If you don't replace reserves you go out of business.

Parenthetically, Mr. Chairman, we are very encouraged by your sensitivity to capital needs as evidenced by your Rangel-Wallop initiative.

There are many marginal wells in the State of New York and, indeed, in the rest of Appalachia. Just as we must preserve the productive capacity of existing wells, the Nation must also encourage investment in drilling for new wells.

Last year, drilling for domestic natural gas and crude oil hit the lowest level since records were kept beginning in the 1940s, and 1993 looks no better. Both government agencies and private analysts have estimated that 500 to 600 rigs need to be drilling for natural gas to meet projected consumption, but only about 300 gas rigs are drilling right now.

The proposals will certainly make a difference for my company, which operates in Kentucky. I operate marginal primary production and marginal water floods. We have used gas for enhanced recovery. We have remediated or plugged over 375 wells under EPA guidelines.

We generate a significant amount of our own electricity from casing head gas to reduce operating expenses, and we have reserves that could be developed in an environmentally safe manner if we could get the capital to develop them. If we can't get the capital, we will not be able to add reserves, and the decline curve will cross over the cost curve, and that will mean lost jobs, lost consumers, lost taxpayers.

My employees are tough people. They have been through hard times with very few raises and far between, but they are survivors. They give me the will to keep fighting.

I am here today to try to save a future for my employees, for all the employees of all the marginal oil and gas producers in the United States, a worthy goal and one I am proud to champion.

Thank you, Mr. Chairman.

Chairman RANGEL. Thank you, Ms. Lazenby.

Ms. LAZENBY. You asked earlier for us to address—I understand that the Treasury Department has opposed this legislation, and——

Chairman RANGEL. Yes, but I was really hoping that those issues might be addressed within the 5 minutes, but it probably will come up.

Ms. LAZENBY. OK.

[The prepared statement and attachment follow:]

INDEPENDENT PETROLEUM ASSOCIATION OF AMERICA

Statement by
Virginia Lazenby
on behalf of the
Independent Petroleum Association of America
before the
Committee on Ways and Means
Subcommittee on Select Revenue Measures

United States House of Representatives
June 24, 1993

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE:

I am Virginia Lazenby. I am from Nashville, Tennessee and Chairman of Bretagne Corporation, a production company with marginal wells operating principally in Kentucky. I appear today on behalf of the Independent Petroleum Association of America, where I serve as the Vice Chair of the Crude Oil Policy Committee. I also am the president of the National Stripper Well Association.

I am pleased to provide views on H.R. 1024, introduced by Congressmen Mike Andrews of Texas and Bill Brewster of Oklahoma. I also want to address the need for changes in tax policy affecting domestic natural gas and oil production and to restate our concerns about tax provisions included in pending deficit reduction legislation.

The focus of H.R. 1024, the Energy Independence, Infrastructure, and Investment Act of 1993, is to maintain and enhance existing domestic natural gas and oil production, especially from economically marginal wells, and to encourage investment in new drilling. Without these or similar changes in tax policy, I am concerned that our nation will grow ever more dependent on imported crude oil as more domestic wells are plugged and abandoned, their resources effectively lost forever.

Our domestic natural gas and oil wells constitute a national security resource. Every barrel of oil and every cubic foot of natural gas produced in the United States creates wealth, jobs and tax revenues at every level of government. Unfortunately, our nation is rapidly losing much of its ability to domestically produce the country's primary sources of energy -- oil and natural gas, which account for about 65 percent of total energy consumption in the United States.

IMPORT DEPENDENCE CLIMBS. Consumption of natural gas and crude oil in the United States, by all official estimates, will continue to rise well into the future. In 1992, our demand for crude oil was almost 18 million barrels per day and 46% of this demand was supplied by foreign oil imports. If current trends continue, the U.S. could be importing 17 million barrels of petroleum each day by the year 2010. This year, the U.S. is projected to import as much or more oil as we did in 1977, the peak year for oil imports.

We have the domestic natural gas resources oil resources to significantly reduce

future foreign oil imports, but these resources will not be discovered and produced so long as this country ignores the fact that the OPEC member governments have more say over U.S. energy economics than the government of the United States, so long as our government sits idly by while every other nation with energy resource potential provides inducements to oil and natural gas investments.

Independent producers, who currently produce about 60 percent of domestic natural gas and about 40 percent of domestic oil, are eager for economic conditions which would allow us to increase domestically produced supplies of natural gas and oil.

MARGINAL WELLS. The nation operated slightly more than 875,000 oil and natural gas wells in 1992, according to *World Oil*. About two-thirds of those wells are oil wells, or about 595,000 wells. Of that total, nearly 78 percent of the nation's oil wells are stripper wells, with an average production per well in 1991 of 2.2 barrels per day.

Marginal wells -- defined as those wells that daily produce less than 15 barrels of oil and 90 thousand cubic feet of gas -- are essential to our domestic energy supply. They provide approximately 20 percent of domestic oil production in the lower 48 states. These high-cost marginal wells collectively produce more oil than we import from Saudi Arabia. Many stripper wells are already uneconomic to operate. Producers continue to operate these wells in hopes of higher future prices, but too often are economically forced to abandon the producing property before the mineral deposit has been exhausted. Stripper wells, which represent over 15% of domestic proved reserves, have been abandoned at rate of over 17,000 wells per year for each of the past 10 years. Once these wells are abandoned their production and proved reserves are permanently lost, and our foreign energy dependency grows.

Congress must adopt measures that improve the economics of investment in this vital segment of our domestic energy supplies, and H.R. 1024 would be an important step in that direction. Let me point out, as the attached map clearly shows, that the greatest beneficiaries of changes in tax policy affecting marginal wells are states not traditionally viewed as "oil producing states."

There are more than 460,000 domestic stripper oil wells in the country. Oklahoma, well known as an oil producing state, has over 73,000 of these wells. But the remaining 390,000 producing stripper wells exist in 27 other states, including New York (3,453 stripper wells), California (25,312 stripper wells), Illinois (34,319 stripper wells) and Kentucky (19,000 stripper wells).

DOMESTIC DRILLING. Just as we must preserve the productive capacity of existing wells, the nation must also encourage investment in drilling for new wells.

Last year, drilling for domestic natural gas and crude oil hit the lowest level since records were kept beginning in the 1940s, and 1993 looks no better. Although the first six weeks of 1993 saw the number of drilling rigs operating elevated producers qualified wells for the expiring non-conventional fuels tax credit, since then the weekly rig counts has fallen below last year's corresponding weekly count. For most of 1993, the year-to-date rotary rig count has declined every week, and currentlv stands at 674, substantially below 1992's annual average of 721. Even though drilling has risen slightly in the last few weeks as natural gas prices rebounded from a 15-year low and gas supply and demand moved closer into balance, it is not inconceivable that a new record low for drilling could be set this year.

H.R. 1024 is intended to spur new drilling, as well as improving the economic life of existing production. The IPAA supports the goals of this proposal; at the same time we have continued to explore alternative approaches to achieve the goals of H.R.

1024. The IPAA Management Committee recently approved a production-based credit proposal for existing marginal wells and new drilling, based on the approach used under the Non-conventional Fuels Tax Credit, as follows:

ELEMENTS OF THE PROPOSAL

I. NEWLY DRILLED WELLS would be eligible for a tax credit, based on production, as follows:

a) Newly drilled natural gas wells would receive a $0.50 per Mcf tax credit for the first 90 Mcf per day. Natural gas production in excess of 90 Mcf per day will receive a tax credit equal to $0.10 for each Mcf of such additional production per day.

b) Oil wells drilled in producing properties which produce an annual per well average of 25 barrels of oil per day or less would receive a production tax credit of $1.55 for each of the first 3 barrels of oil produced per well per day. The annual average production would be determined after considering the production from the newly drilled well.

c) Oil wells drilled in nonproducing properties which produce an annual per well average of 25 barrels of oil per day or less, would receive a production tax credit of $1.55 for each of the first 15 barrels of oil produced per well per day.

II. EXISTING STRIPPER WELLS. Existing oil and/or natural gas wells which on the date of enactment or subsequently qualify as a Stripper Well property would receive a production tax credit in the following amounts:

a) Oil: $1.55 for each barrel of daily production up to 3 barrel per day maximum.

b) Natural Gas: $0.268 per mcf of daily production up to 18 mcf per day maximum.

III. OTHER CHARACTERISTICS

- Effective for production after June 1, 1994. The rate of the tax credit would be phased-in by one-third each year between 1994 and 1996, and indexed for inflation thereafter.
- Available to carry back 3 years (but not to a year which precedes the enactment date) and carry forward 15 years.
- Creditable against regular tax and alternative minimum tax, but not refundable.
- Available to working interest owners only. The credit would not be allowable for interests held by nonworking interest royalty owners, or royalty interests held by nonprofit organizations such as governments, universities or Indian tribes, etc.
- Workovers and recompletions earn the new well credit on the incremental production.
- Only wells operating at their most efficient flow rate would qualify for the tax credit. Otherwise qualifying stripper wells operating at reduced production rates in accordance with state regulation will not be disqualified.

- Stripper wells which have increased their efficient production through work-over expenditures to levels in excess of the stripper well rate will be allowed to retain eligibility for the tax credit for production up to the stripper well limits. (Qualification would continue under provisions similar to the newly drilled well limitations.)

- Existing Section 29 wells not be eligible for the marginal well production tax credit, until the existing Section 29 tax credit expires.

- Properties producing both oil and natural gas, a conversion ratio of 6 Mcf per barrel of oil would be used to calculate equivalent oil production, and eligibility would be determined by adding barrels of oil produced to the oil-equivalent of gas produced from each well.

* * *

NATURAL GAS DRILLING. The tax proposals outlined above will attract new capital and new drilling activity to all geographic regions of the domestic industry. It is needed. For the first time in several years, the industry needs to increase natural gas drilling levels to meet demand. Government agencies and private analysts have estimated that 500-600 rigs need to be drilling for natural gas to meet projected consumption. Only 298 gas rigs were drilling the week of May 7, 1993.

Equally important, the production-based credit will give a signal to domestic producers that their industry's contributions are viewed as necessary to achieve the administration's energy independence and economic recovery goals. It will also signal that the health of the domestic oil and gas industry is important to this administration and that the industry is not being singled out for the economic penalties which are inherent in all energy taxes.

REVENUE OFFSET. The revenue offset proposed by H.R. 1024 to pay for production and drilling tax changes could be used for the proposal outlined above. H.R. 1024 proposes an increase in fees on imported oil and petroleum products. While this is a preferred revenue offset from IPAA's perspective, the proposal for increased in fees on imported gasoline, advocated by domestic independent refiners, is also acceptable to IPAA if used to provide tax policy changes for domestic production and drilling.

* * *

ADMINISTRATION'S POSITION. Mr. Chairman, I would like to respond to the statement by Assistant Treasury Secretary Leslie Samuels opposing the proposed changes in energy tax policy. The IPAA believes that Mr. Samuels is not only wrong in his assessment of recent tax law changes affecting marginal wells, but that his statement, to the extent that it relies on energy policy grounds, is at odds with intent of the Administration's initiative (being coordinated by the Department of Energy) to find ways to stimulate the domestic oil and natural gas industry. With Mr. Samuels' statement, the Administration appears to be sending out conflicting signals about the need to increase domestic oil and natural gas exploration and production.

While changes affecting marginal properties were made in recent tax [illegible] is inaccurate to describe those changes as "substantial." For instance, changes were made recently in percentage depletion, the tax provision providing for capital recovery from mineral deposit leasehold expenditures, that increased the rate of percentage depletion for marginal properties to 19 percent and eliminated percentage depletion as a preference item under the alternative minimum tax. Unfortunately, these changes in percentage depletion look better in the tax code than on producers tax returns.

While stripper wells are eligible for percentage depletion rate of 19 percent,

due to the net income limitation, the tax benefit to producers can be eliminated altogether and, on average, produces a percentage depletion rate as low as 2 percent. In other words, because most stripper wells are operated at a loss or generate very little income, they are denied the tax deductions properly allowed to other oil and gas properties, principally because of the net income limitation. To the extent that the net income limitation denies substantial regular tax benefit to independent producers from percentage depletion, the recent elimination of the AMT preference is practically inconsequential. At the time the changes were made in percentage depletion for marginal wells, IPAA urged Congress to also repeal the net income limitation to make those changes effectual. The repeal of the net income limitation is sorely needed to give meaning to previous congressional action and, as for as maintaining and enhancing existing production is concerned, is one of the most important aspects of H.R. 1024.

Changes were also recently made in the AMT preference treatment of intangible drilling costs, the expenditures made during the drilling phase of an oil and natural gas producer's operations. These costs represent the ordinary and necessary business expenditures made by the petroleum industry. The allowance of a current tax deduction merely provides the petroleum industry with equitable tax treatment with other industries. This change has no impact on stripper wells. Stripper wells are older, existing properties which have already borne their drilling costs.

* * *

Let me also reiterate IPAA's views on proposed energy taxes. Our testimony on April 20th before the full Ways and Means Committee centered on the Administration's proposed BTU tax; even with the changes made by the Committee, enactment of the BTU tax will have adverse economic impacts on the domestic oil and natural gas industry, impacts that will not be felt by foreign energy suppliers. This disparity justifies an increase in fees on imported oil and petroleum products, as well as provisions to preserve production from U.S. marginal wells and encourage new drilling. H.R. 1024 combines these initiatives.

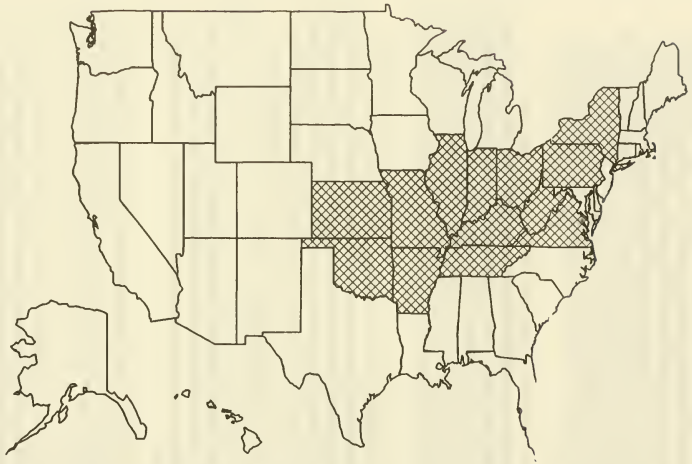
Marginal wells will be particularly hard hit by the BTU tax. For example, the vast majority of stripper wells operate on artificial lift, and most use electricity for that purpose. In some cases, the costs of electricity alone is more than 50 percent of all production costs.

Even without the BTU tax, domestic independent producers are going to be hit hard by the tax increases on small businesses. The vast majority of independents operate as proprietorships, partnership or Subchapter S Corporations that pay taxes at the personal tax rate.

The increase in the top marginal rate to 36% on taxable income above $140,000 ($115,000 for singles), combined with the 10% surtax on taxable income in excess of $250,000 and the repeal of the ceiling for the 2.9% Medicare payroll tax added to the phase-out of personal exemptions and itemized deductions, yield a marginal tax rate of 44.5 percent for a self-employed individual with taxable income [illegible] $250,000 who has 4 exemptions and itemized deductions.

These tax provisions will hit capital intensive businesses like ours especially hard. At a time when the typical natural gas well costs $506,000 to drill, government plans to increase its take by more than one-third of any income above $250,000. For independents, who have to get most of their drilling funds from internally generated capital, the personal tax increases are going to be devastating.

STATES WITH 50% OR MORE STRIPPER WELL PRODUCTION



% of Total Crude Oil Output produced by Stripper Wells

Arkansas	52%	Kentucky	83%	Ohio	73%	Tennessee	81%
Illinois	93%	Missouri	86%	Oklahoma	75%	Virginia	100%
Indiana	100%	New York	88%	Pennsylvania	100%	W. Virginia	99%
Kansas	71%						

Source: National Stripper Well Association

Chairman RANGEL. Ms. Zimmerman, Alliance to Save Energy.

STATEMENT OF MARY BETH ZIMMERMAN, ECONOMIST, ALLIANCE TO SAVE ENERGY

Ms. ZIMMERMAN. Mr. Chairman, thank you.

My name is Mary Beth Zimmerman. I am an economist with the Alliance to Save Energy, which is a nonprofit coalition dedicated to increasing investment in energy efficiency. I appreciate the opportunity to be here this morning.

I am focusing today on a bill recently introduced by Congressman McDermott, H.R. 2026, as an example of how tax policy can better reflect our Nation's energy and environmental goals. I will be submitting a letter endorsing this bill by the Natural Resources Defense Council, Friends of the Earth, and the Alliance for the record.

Many of the provisions in our current Tax Code help shape the way we use energy in the United States. The Alliance to Save Energy recently published an analysis of both tax- and program-related Federal energy subsidies available in 1989. I stress that we do not regard the individual subsidies included in this analysis as necessarily bad, but we do believe that the overall pattern of subsidies influences our Nation's energy policies and choices.

The Federal Government provides a minimum of $20 billion in energy-related subsidies. Valued at market rates these subsidies are worth up to $36 billion.

Tax policy is a major component of the subsidy picture. Between $7.5 and $18 billion in subsidies were provided to the energy sector through the Tax Code in 1989. Many of the capital-related subsidies were phased out under the 1986 Tax Reform Act, but the residual impacts have been large.

Eighty-five to ninety percent of these tax breaks are attributable to conventional fuels overall, as opposed to some 15 percent attributable to nonconventional energy, including energy efficiency. About two-thirds can be attributed to fossil fuel production consumption and electricity generation.

Only 2 to 4 percent of all tax-related subsidies were available—were utilized by energy efficiency investments. These disparities are so large that an embedded advantage for conventional energy resources is clear.

These Tax Code biases hamper competitiveness, energy security and the environment. The energy choices available to us in the future depend upon whether we facilitate the development of new and clean domestic energy options today. The world market for energy efficient products and clean energy resources will grow enormously over the next several decades.

Energy efficient products and renewable energy technologies are resources we can produce at home. They can help us both reduce our trade deficit by reducing the need for imported oil and through their export potential.

In a study undertaken by the Alliance to Save Energy, the American Gas Association, and the Solar Energy Industries Association, we found that cost-effective energy investments would create a net addition of up to 152,000 jobs by the year 2000 and 365,000 new jobs by the year 2010.

Unfortunately, countries do not compete with old technologies. The financial disincentives for emerging energy options imbeded in our Tax Code jeopardizes our Nation's chances of developing a strong, competitive new domestic energy industry.

The Tax Code also subsidizes polluting and environmentally risky energy sources over cleaner alternatives. Fossil fuels account for about two-thirds of all tax subsidies, including fossil-generated electricity. Within the fossil sector, coal and oil are more heavily subsidized than is natural gas. These subsidies work at cross purposes to our Federal clean air and water goals, including achievement of carbon dioxide emission goals. Our tax policy can reflect strong energy and environmental goals.

The subsidy picture described above calls for two major responses. First, we must change the existing subsidy landscape with a leveling of the playing field our first priority. Second, new tax proposals should be evaluated in light of the overall subsidy picture rather than in isolation. In both cases, the energy and environmental impacts should be weighed explicitly.

Sound energy policy requires that the Tax Code foster the development of new, clean domestic energy industries, including energy efficiency industries. Unfortunately, the prevalence of subsidies throughout this century means that even a level playing field may not be very level. Targeted benefits for emerging energy resources should be designed to both help overcome the generic barriers to any new sector, such as the lack of sufficient R&D, as well as lingering barriers created by the historic subsidy of traditional energy supplies.

Sound environmental policy requires that the environmental costs be taken into account in subsidy choices and that our Tax Code encourages a shift toward cleaner energy resources. Current subsidies to heavily polluting energy resources send exactly the wrong market signal and need to be eliminated. Our assessment of environmental impacts need not be perfect to move us in this direction, but the change in incentives should be decisive.

Let me stress that these changes do not require us to pick individual winners and losers in energy markets, merely to open energy markets to new opportunities and possibilities. Indeed, reducing the biases that already exist in our Tax Code is an important step away from government-selected energy favorites.

H.R. 2026 begins the critical process of changing the way we look at tax policy. It offers concrete steps toward a balanced and forward-looking energy subsidy picture. The package sends a clear message that tax choices should be made in light of the overall pattern of energy subsidies. The effect of this package as a whole is to shift Federal tax incentives toward newer and cleaner energy options.

Thank you.

[The prepared statement and letter referred to follow:]

STATEMENT OF MARY BETH ZIMMERMAN,
ECONOMIST, THE ALLIANCE TO SAVE ENERGY

Mr. Chairman, Members of the Subcommittee:

My name is Mary Beth Zimmerman and I am an economist with the Alliance to Save Energy, a non-profit coalition of government, industry, consumer and environmental leaders dedicated to increasing investment in energy efficiency. I very much appreciate the opportunity to testify before the Ways and Means Subcommimttee on Select Revenues. I focus today on a bill recently introduced by Congressman McDermott's bill, H.R. 2026, as an example of how tax policy can better reflect our nation's energy and environmental goals.

Tax Policy is Energy Policy

It is time for a change in the way we view tax policy. Many of the provisions in our current tax code, and many of the provisions that regularly come before this Committee, help shape the way we use energy in the United States. This is true not only of the provisions that provide special tax treatment for specific energy sectors, such as oil and gas production, but for provisions that benefit related sectors of the economy, such as transportation and agriculture, and those that broadly benefit capital investment.

Markets do work and tax subsidies which make it less expensive to produce and consume energy promote energy consumption, and foster waste and inefficiency. As a result, our federal tax policy must be viewed as a critical component of our nation's energy and environmental policy. As a whole, the current tax code obstructs the development of new domestic energy markets which can contribute to improved competitiveness, energy security, and environmental well being. I am here today to discuss principles we can use to change the tax code in ways which promote a strong energy and environmental future. H.R. 2026 is an example of this new approach to tax policy. I am optimistic that as the role of fiscal policy in our environmental well being becomes better understood, the impetus for reform will grow.

Federal Energy Tax Subsidies

The Alliance to Save Energy recently published a landmark study of federal energy subsidies.[1] The report, authored by Douglas Koplow, examined both tax and program-related subsidies available in 1989 and is the most comprehensive picture available of federal energy market interventions. We considered both direct subsidies to specific energy sources, and general subsidies to housing, capital, or other investments which are extensively used in the energy sector. We even estimate the portion of the mortgage interest deduction attributable to energy efficiency investments financed through home mortgages. I stress that we do not regard the individual subsidies included in this analysis as necessarily "bad"; but we do believe that the overall pattern of subsidies influences our nation's energy policies and choices.

There is no free market in energy. The federal government provides a minimum of $20 billion in energy-related subsidies. Valued at market rates, these subsidies are worth up to $36 billion. These numbers are certainly large enough to affect our nation's energy choices. Of this $36 billion, $35 billion in benefits accrued to energy supplies; only $1 billion benefitted energy efficiency improvements. Conventional energy resources -- oil, gas, coal, nuclear, and hydroelectric power -- received eight and one-half dollars worth of subsidies for every one dollar received by all emerging energy resources combined -- from wind to fusion power, from energy efficiency to biomass. We define subsidies as government-provided goods or services, including risk-bearing, that otherwise would have had to be purchased in the market, as well as reductions in tax burdens compared to the standard treatment for a similar activity.

Subsidy bases remain even when we adjust subsidy estimates for market share. Whereas the direct use of fossil fuels, for instance, receives 20 to 25 cents per million Btus in subsidies, end use energy efficiency receives about 6 cents. The difference is even larger when we look at the subsidies attributable to electricity consumption; for fossil fuels, these range from about $1 to $1.40 per million Btus. The subsidies associated with fission power are about $5.80 per million Btus. Electricity subsidies include subsidies to the production of energy used for electricity generation and subsidies to electricity generation per se. They also account for the fact that about three Btus of energy input are required for every Btu of electricity consumed.

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[1]Douglas N. Koplow, *Federal Energy Subsidies: Energy, Environmental, and Fiscal Impacts*," Alliance to Save Energy, Washington, DC, 1993.

Tax policy is a major component of this subsidy picture.

Our analysis suggests that between $7.7 to $18.1 billion in subsidies were provided to the energy sector through the tax code in 1989. This estimate is based in part on Joint Tax Committee and U.S. Treasury scoring of specific tax provisions, as well as our own calculations regarding capital investments in energy supply and energy efficiency during the 1980s.

We distinguished between energy provisions which are specifically related to the energy sector, about 30% of the total; those provided to capital investment overall, about 65% of the total; and those related to non-energy sectors of the economy, accounting for about 5%. The bulk of the capital-related subsidies were phased-out under the 1986 Tax Reform Act -- the investment tax credit and accelerated depreciation in particular -- but their prior availability continues to affect energy markets through long-lived capital choices.

The bias towards conventional energy sources identified above remains when we look specifically at tax-related subsidies. 85% to 90% are attributable to conventional fuels overall, as opposed to some 15% attributable to non-conventional energy, including energy efficiency. About two-thirds can be attributed to fossil fuel production, consumption, and electricity generation.

These percentages change from year to year as the tax code and level of activity in energy markets change. Nonetheless, the disparities are so large that an embedded advantage for conventional energy resources is clear.

This bias results in large part from a factor we might refer to as "subsidy creep." Our conventional energy sources have had decades to accrue subsidies. Many of these provisions were sound at the time they were adopted, but the original rationale for the subsidy may have long since evaporated. Each subsidy, unfortunately, triggers a game of "catch up" as other portions of the energy market try to level the playing field. The net result over time is a ratcheting up of the playing field overall.

The good news is that the 1986 Tax Reform Act and other measures have helped lower the overall level of subsidies. We estimate that if 1993 legislative provisions were applicable in 1989, subsidy levels would be as much as $3.5 billion lower, or about $30 billion overall. Unfortunately, subsidies continue to be added back into the mix. The oil and gas minimum tax relief included in the Energy Policy Act of 1992, for instance, adds some $ 170 million in new energy subsidies. Subsidy creep and biases are much more likely to continue when individual tax breaks are proposed and considered in isolation, without reference to the overall picture of energy subsidies.

Tax Code Biases Hamper Competitiveness, Energy Security and the Environment

The energy choices available to us in the future depend upon whether we facilitate the development of new and clean domestic energy options today. Energy efficiency and renewable energy resources can improve our competitiveness, energy security, and environment. Although they both are used today, their full potential -- and benefits to our economy and environment -- will remain untapped as long as federal subsidies favor conventional energy sources and encourage increased energy consumption.

Competitiveness

A growing world-wide focus on, and commitment to, environmental quality has generated increased interest in clean and efficient energy options. This interest coincides with rapidly growing demand for energy -- electricity in particular -- in much of the developing world. The market for energy efficient products and clean energy resources will grow enormously over the next several decades. A recent Alliance to Save Energy analysis estimated the market for energy efficient industrial equipment at $20 billion in eastern Europe alone.[2] Counties such as

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[2]Mark Hopkins, "Business Opportunities in Eastern Europe for Energy-Efficient Industrial Products," January 1992.

Thailand are already looking to the United States for successful models of implementing energy efficiency improvements.

The good news is that energy efficient products and renewable energy technologies are energy resources we can produce in the United States. They can help us reduce our trade deficit both by reducing the need for imported oil and through their export potential. In addition, cost-effective efficiency improvements lower the cost of manufacturing, freeing up dollars for new investments and making domestically produced products more competitive.

Changing the way we use energy can create jobs as well. Energy efficiency and renewable energy production are more labor intensive than the production of conventional energy resources. In a study undertaken by the Alliance to Save Energy, the American Gas Association, and the Solar Energy Industries Association,[3] we found that cost-effective energy investments would create a *net* addition of 83,000 to 152,000 jobs by 2000 and 176,000 to 365,000 new jobs by 2010. These gains are before taking account of the export opportunities for these new industries.

Unfortunately, countries do not compete with old technologies and countries which support conventional over emerging industries are likely to lose out in an increasingly competitive and international energy market. The financial disincentives for emerging energy options imbedded in our tax code jeopardizes our nation's chances of developing a strong, competitive new domestic energy industry.

Energy security

We import some 40% of the oil consumed in the United States, at a cost of over $40 billion a year. Unfortunately, imports are expected to rise steadily in the decades ahead, from 7.17 million barrels per day (mmb/d) in 1990 to over 12 mmb/d in 2010.[4] Policies that encourage temporary surges in domestic production, or reduce the cost of developing marginal reserves cannot overcome the fact that the large, low-cost sources of oil are located outside the United States. Unfortunately, as energy subsidies encourage increased consumption, they hasten the move towards increasing dependence on imported supplies. The real keys to improved energy security are a reduced overall dependence on fuels and increased diversity in energy supplies. Energy efficiency and renewable energy offer both.

Environment

Not all conventional energy sources are heavily polluting; nor are all emerging resources non-polluting. Even when we take this caveat into account, however, the tax code subsidizes polluting and environmental risky energy sources over cleaner emerging alternatives. Fossil fuels account for about half of all tax subsidies in their production and direct consumption; they rise to two-thirds of all subsidies if fossil-generated electricity is included. Within the fossil sector, coal and oil are more heavily subsidized than is natural gas. These subsidies work at cross-purposes to our federal clean air and water goals, including efforts to achieve carbon dioxide emissions goals. Nuclear power accounts for roughly another one-fifth of our tax subsidies.

In sharp contrast, wind, solar, geothermal, and non-ethanol biomass account for only 3% to 4% of all tax subsidies; energy efficiency for another 2% to 4%. Our cleanest fuels are being competing with a large disadvantage on the tax subsidy front.

The market signals generated by government-provided subsidies should roughly reflect the environmental costs and benefits of different energy futures. The current subsidy mix provides exactly the opposite set of signals.

Tax Policy that Reflects Strong Energy and Environmental Goals

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[3] *An Alternative Energy Future*, April 1992.

[4] DOE/EIA, *Annual Energy Outlook, 1993*, January 1993.

The subsidy picture described above calls for two major responses. First, we must change the existing subsidy landscape, with a leveling of the playing field the first priority in this regard. Second, new tax proposals should be evaluated in light of the overall subsidy picture, rather than in isolation. In both cases, the energy and environmental impacts should be weighed explicitly.

Sound energy policy requires that the tax code foster the development of new, domestic energy industries, including energy efficiency industries. Dollars spent on conventional energy sources are lost opportunities for our energy future since they raises the threshold for new competing energy resources. Eliminating subsidies to conventional energy resources helps remove the hurdles to rapid development of competitive emerging energy resources. Unfortunately, the prevalence of subsidies throughout this century means that even a level playing field may not be very level. Targeted benefits for emerging energy resources should be designed to both help overcome the generic barriers to any new sector – such as lack of sufficient R&D – as well as lingering barriers created by the historic subsidy of traditional energy supplies.

Sound environmental policy requires that environmental costs be taken into account in subsidy choices, and that our tax code encourages a shift towards cleaner energy resources. Certainly, current subsidies to heavily polluting energy resources send exactly the wrong market signal and need to be eliminated. Our assessment of environmental impacts need not be perfect to move us in this direction, but the change in incentives should be decisive.

Let me stress that these changes do not require us to pick individual winners and losers in energy markets, merely to open energy markets to new opportunities and possibilities. Indeed, reducing the biases that already exist in our tax code is an important step away from government-selected energy favorites.

Acting on Energy and Environmental Goals

H.R. 2026 begins the critical process of changing the way we look at tax policy. It offers concrete steps towards a balanced and forward-looking energy subsidy picture. Proposals for eliminating and reducing existing subsidies to conventional energy sources are balanced with targeted opportunities for an expanded role for energy efficiency and renewable energy resources in our energy markets. The package sends the clear message that tax choices should be made in light of the overall pattern of energy subsidies. The effect of this package as a whole is to shift federal tax incentives towards newer and cleaner energy options.

Providing new subsidies is always less painful in the short run than eliminating old subsidies. Yet it is clear from the picture of federal energy subsidies described above that no real progress can be made in moving our country towards a new, more competitive energy future without addressing the preponderance of subsidies accruing directly or indirectly to conventional energy resources. Reducing subsidies to conventional and polluting energy sources is a win-win combination of fiscal prudence and energy and environmental progress.

World energy markets will not wait. We need to begin now to make fundamental changes in our energy tax subsidy picture, and to ensure continued progress towards a balanced and forward-looking energy tax picture. This change should take the form of specific efforts to reduce existing energy subsidies as well as a new approach to all new tax proposals, one which explicitly takes its energy and environmental impacts into account. If we follow this approach, the next study of federal energy subsidies will reveal a very different pattern, and the growth of new energy efficiency and renewable energy markets will underscore the results.

Again, let me thank you for the opportunity to address the Subcommittee.

ALLIANCE TO SAVE ENERGY * FRIENDS OF THE EARTH
NATURAL RESOURCES DEFENSE COUNCIL

June 25, 1993

Honorable Jim McDermott
1707 Longworth House Office Building
U.S. House of Representatives
Washington, D.C. 20515

Dear Representative McDermott:

We would like to commend you for developing The Renewables and Energy Efficiency Incentives Act of 1993 (H.R. 2026). The bill represents a coherent effort to reform our nation's tax code by rejecting the current practice of subsiding mature, polluting energy sources at the expense of efficiency and clean, emerging technologies. This legislation will push the nation in a new direction, toward a future which values environmental quality and economic vitality.

We are grateful for your past support of environmentally friendly tax measures, particularly your efforts last year in the Ways and Means Committee to include a package of environmentally friendly tax measures in the National Energy Policy Act. H.R. 2026 is a natural outgrowth of those earlier efforts to rationalize policy for development of energy efficiency and renewable energy sources while eliminating subsidies for dirty and dangerous sources.

As you know, the tax code powerfully influences the investment and research decisions made by companies and individuals. By removing obsolete subsidies for conventional energy sources, H.R. 2026 will reduce a major obstacle to developing cleaner energy alternatives. In addition, providing targeted incentives for emerging technologies is good policy to improve our country's economic competitiveness in the emerging global markets and to assure that future growth will not exact a high cost in environmental degradation.

Once again, we thank you for your efforts in this crucial area. We look forward to working closely with you to advance your legislation.

Sincerely,

Dawn Erlandson

Dawn Erlandson
Director, Tax Policy Project
FRIENDS OF THE EARTH

On behalf of:

Dan Lashof
Senior Scientist
NATURAL RESOURCES DEFENSE COUNCIL

Mary Beth Zimmerman
Senior Program Manager
ALLIANCE TO SAVE ENERGY

Chairman RANGEL. Mr. Sklar.

STATEMENT OF SCOTT SKLAR, EXECUTIVE DIRECTOR, SOLAR ENERGY INDUSTRIES ASSOCIATION

Mr. SKLAR. Thank you, Mr. Chairman.

The Solar Energy Industries Association is the trade association of the photovoltaics and solar thermal manufacturers and component suppliers.

I want to start off by thanking this subcommittee and the full committee for extending the solar business credits last year. On a personal note I want to say this New York City born and raised and now Virginia resident lost most of his hair due to last-minute extensions on this issue, and I am glad I don't have to face that anymore.

On the solar side, we have 60 utilities working with our industry to scale up manufacturing to procure photovoltaic solar electric technology in cost-effective applications. We have had three manufacturing facilities upgraded in 1992 in California, Maryland and the State of Washington. We have two more being built in 1993 in California and Norfolk, Va., and we have five more in 1994–95, in large part, due to the work of this committee supporting investments in this kind of high-technology industry.

On the solar steam side and electric side, we have a consortia of utilities upgrading the Solar One plant, the first base load plant that can produce steam to make electricity day or night, rain or shine, and we expect 10 facilities like this in this decade. Solar dish engine technology, a new kind of solar driven engine, and solar trough technology will start being deployed again in this decade.

Solar water heating sales are bullish and mostly going into the institutional building sector, and extending the business credit will move it into the commercial sector.

I want to point out in the last page of my testimony we have a chart showing jobs related to making solar equipment versus making automobiles, and you will find the same components, materials and skills are required in both industries. And I think that, as the statistics that Mary Beth Zimmerman of the Alliance quoted from our joint study, 350,000 plus jobs is a GM-sized set of industries that is worth your attention.

So with all this good news, why are we here? We want two minor technical corrections in the energy policy act.

One, utilities are excluded from getting the investment tax credit. A commercial enterprise can get it. An independent private power producer who supplies power to a utility can get it. But with solar, unlike many of the other renewables, most of our technology will be defused and used by the utility industry, and we need them to be partners in this.

There is no policy reason for this. This is a quirk. We would like it fixed.

In addition, the investment tax credit can be used for solar water heating, and it can be used for electricity production, but it can't be used for steam. Steam is a major market, so we would just like to make sure that the Congress isn't saying which markets. It ought to be just promoting solar. There is no reason for that, either.

In regard to H.R. 2026 that was introduced by the esteemed and great Representative McDermott, he had put two great provisions in there for solar energy: Limited AMT relief, which, obviously, we support. And this is not to be greedy, frankly. This is because we are marginally profitable, and until we can build new manufacturing and build deployment, we can't take advantage of some of these tax incentives without it.

And the second one is a change in the solar property definition which allows that solar equipment that at least provides 51 percent of the energy can receive the credit. There was an arbitrary 75 percent figure.

What these changes will do is just further drive our industry—and I would like to note that right now the international markets have been driving our industry. Two billion people around the world don't have access to electricity. Renewable energy and solar in particular is one of the least-cost solutions to do it.

The United States leads technologically. One of our companies that will be building a pilot plant in 1996, Cummins Engine—I brought a picture. This is the solar-driven engine I am talking about. A pilot facility is in the plans to build 50 of these in 1996, and by the end of this decade it will be in the hundreds. You can use solar during the day and natural gas or biogas at night, and this is a very versatile technology in areas of the world that don't have access to electricity or this kind of technology.

And I would like to conclude that this committee and the Congress has really been a supporter of this industry. We need some minor fine tuning, but it will drive lots of jobs, keep the U.S. competitive edge. And if we don't build our markets domestically, we will not be able to dominate the multibillion dollar markets at the end of this decade for our technologies. And thanks for the time.

[The prepared statement and attachment follow:]

STATEMENT OF SCOTT SKLAR,
EXECUTIVE DIRECTOR, SOLAR ENERGY INDUSTRIES ASSOCIATION

INTRODUCTION

The Solar Energy Industries Association (SEIA), the national trade organization of the photovoltaics and solar thermal manufacturers and component suppliers, wishes to thank the House Ways and Means Committee for extending the business investment tax credit for solar applications. The extension of the 10 percent commercial credit, absent any expiration date, was essential to show clear, consistent federal support for solar energy investments.

While this credit has been and continues to be highly beneficial to our industry, it needs strengthening. The Renewables and Energy Efficiency Incentives Act of 1993 represents a good beginning to this process. But SEIA urges the Committee to adopt three simple but important technical modifications to the existing tax code to render it more useful and equitable to the solar energy industries.

The tax credit has already attracted capital to our industries. Sales for solar water heating have grown over 15 percent annually. The utility industry is now forming a collaborative called "Solar H_2O" to aggregate markets for solar water heating. This important exercise will allow industry to attract the private capital needed to scale-up manufacturing and thus reduce costs, allowing the further expansion of commercial markets. This year, one solar [water heating system] manufacturer has scaled-up and automated its plant; others are planning to follow suit in the near future.

A newly formed, 63-member utility consortium -- in concert with a collaborative known as "PV For Utilities" (comprised of key players from the utility, regulatory, PV industry, government, and consumer groups) -- has embarked on a mission to create a 50 megawatt-per-year market for photovoltaics, using staged procurements and sequential purchases of already cost-effective applications. In 1992, two of the largest photovoltaic manufacturers scaled-up and automated their manufacturing facilities, and two other manufacturers have announced new automated facilities in 1993. The technical amendments we seek today would ensure the construction of at least five new automated facilities in the United States by 1995.

Solar thermal technologies are also on the cusp of new commercial activities. A consortium led by Southern California Edison is upgrading and converting the 10 megawatt solar central receiver in Barstow, California with new stretched-membrane heliostats (mirrors) and a molten salt storage system. Once the Solar Two prototype is validated, several utilities are planning to order the first baseload solar generating technology which will be able to produce electricity, rain or shine, night or day. Another solar thermal technology, the dish-engine system, where a reflective dish concentrates solar energy to power an external combustion engine, is nearing commercialization. The smaller of these systems -- a 7-kilowatt system designed for remote power applications -- is being demonstrated successfully in states all over the country, including Pennsylvania. Several major utilities have also committed to cost-sharing a joint ventures program to test and validate a larger, 25-kilowatt dish-engine system capable of delivering utility-grade power. Three U.S. engine companies, Cummins, Detroit Diesel, and Westinghouse, are in a race towards pilot production facilities for this technology in the late 1990s. Finally, the most proven solar thermal technology, the parabolic trough, is used to produce 385 megawatts of power in Southern California at five generating plants as well as to produce process heat for numerous facilities in western states. A new industry consortium is forming to market and deploy a new generation of

these technologies.

For the U.S. solar industry to scale-up manufacturing and to substantially penetrate the U.S. energy markets, it must forge a long-term partnership with the utility sector. SEIA has three suggestions to ensure that U.S. tax policy promotes this strategic alliance:

- Allow utilities to utilize the existing 10 percent solar business energy tax credit.
- Broaden the definition of solar property to include "dual use" equipment that is at least 51 percent solar, and equipment which produces steam for industrial processes.
- Treat the U.S. solar industry equitably with other domestic energy producers by providing partial relief from the alternate minimum tax (AMT).

These technical corrections will strengthen and focus the solar incentives already passed, and will provide more equity to the now biased federal subsidies for conventional and more entrenched domestic energy industries.

Each of our three proposed changes are described in detail below.

1). EXTEND ELIGIBILITY FOR THE SOLAR BUSINESS TAX CREDIT TO UTILITIES

Currently, the solar business energy tax credit extends eligibility to commercial users, private power, and independent power producers, but not to private utilities. To exclude utilities from the business energy tax credit for solar energy is inconsistent with other incentives promoting renewable energy technologies. Under the Energy Policy Act, eligibility for a 1.5-cents-per-kilowatt-hour tax credit is extended to investor-owned utilities that produce power using wind and closed-loop biomass. In addition, public utilities are eligible to receive a production incentive payment, also at the rate of 1.5 cents per kilowatt-hour of energy produced using renewable energy, for which the Administration has proposed a funding level of $2 million for FY 1994.

Extending the tax credit to utilities is a key ingredient in the set of market conditions needed for solar energy diffuse rapidly within the utility sector, and should be included in H.R. 2026. Since it is unlikely that the solar energy industry can mature and grow to its full market potential without the participation of utilities, this amendment to the tax code is one of the highest priorities of the solar energy industry. Extending eligibility of this tax credit to utilities would be strongly supported by the Edison Electric Institute, the American Gas Association, and the utility collaboratives formed to increase deployment of solar energy mentioned above.

2). BROADEN THE DEFINITION OF QUALIFYING SOLAR PROPERTY

The definition of qualified solar property should be modified in two ways:

First, it should allow the credit to be claimed for the solar portion of "dual use" equipment (such as hybrid systems which use solar energy combined with another energy source to produce energy) for which solar power contributes at least 51 percent of the overall energy produced. Section 104 of H.R. 2026 accomplishes this change by including specific statutory language in section 48 of the tax code. While the existing current tax code does not directly address this issue, the current definition of solar property relies on statutory language pertaining to steam-to-electric trough technology in the Public Utility Regulatory Policies Act (PURPA). Qualified property excludes "dual use" equipment which derives less than 75 percent of its energy from solar energy. Many solar systems which use a back-up energy source are currently excluded from eligibility because of this restriction. Extending the definition to systems that are predominantly solar is only logical, in that it equally treats all solar commercial heat and electric applications. This definition insures that the credit can be used only for the solar property installed as per the original intent.

Second, the definition of solar property should explicitly include equipment that produces steam, such as for industrial process or industrial process preheat. This correction is not included in H.R. 2026. Solar equipment that produces hot water for such processes is currently eligible. We believe the interpretation of the definition to exclude non-electric steam-producing equipment is mistaken and should be corrected to allow eligibility for a group of solar process heat technologies for which there is a growing market demand.

The industry believes these technical corrections will clear perceived impediments to use solar technologies in the industrial process heat and steam applications, as well as clarify allowable solar technologies in hybrid applications.

3). ALTERNATIVE MINIMUM TAX RELIEF

Two issues need to be addressed regarding Alternative Minimum Tax (AMT) relief:

First, the Congress approved AMT relief for domestic oil and gas producers. Our emerging industries, who are also domestic energy producers and who must compete with conventional industries, are once again placed in a competitive disadvantage.

Second, our industries are less than fifteen years old and are predominantly small businesses. Existing solar incentives are important but still do not adequately compensate for our marginal profitability and our current situation in which an exceedingly high share of income is focussed towards R&D and marketing.

The AMT provisions embodied in the Renewables and Energy Efficiency Incentives Act of 1993 are exactly what our industry believes is fair and adequate. The partial AMT relief provides equity between domestic energy producers, yet still embodies the basic principle of the need of a minimum corporate tax.

CONCLUSION

The U.S. solar industry is on the growth curve. Overseas sales for photovoltaics have topped 60 percent in 1992, but the only way U.S. can dominate the potential multi-billion dollar global markets for sustainable energy is by building our markets domestically. Solar water heating has dropped in costs and increased in reliability with solar water heating systems now certified by the Solar Rating and Certification Corporation (SRCC), the non-profit entity supported by the U.S. Department of Energy and State Energy Offices. Concentrated solar technologies, including central receiver, dish engine, and trough technologies are all poised to increase market penetration in the 1990's to provide energy for industrial process heat and pre-heat, peak power and baseload electricity.

Our industries thank the Committee for its support and hope that the technical issues we raised can be addressed positively and forthrightly in this session of Congress.

APPENDIX

SOLAR ENERGY CREATES JOBS

U.S. Direct Jobs Per Million Dollars of Annual Expenditure, 1990

Construction	13.30
Solar Water Heater Manufacturer	9.9
Manufacturing	8.85
Electric Utilities	4.73
Coal Mining	4.38
Natural Gas Utilities	2.84
Oil and Gas Exploration	1.51

Derived from the Bureau of Labor Statistics Annual Wage and Salary Employment Data

Solar Industry Creates High Technology Employment Similar to the Automobile Industry While Lowering Energy Imports and Air Pollution

	Solar Industry Potential (10 million Collectors per Year at 400 lbs. per Collector)	Auto Industry (8 Million Cars per Year at 3,000 lbs. per Car)	Job Types: Americans Making Products for Americans
Materials Suppliers	• Steel • Plastics • Glass • Copper • Aluminum	• Steel • Plastics • Glass • Copper • Aluminum	• Mine workers • Refining workers • Smelting workers
Component Suppliers	• Stampings • Electronics • Mouldings • Formings	• Stampings • Electronics • Mouldings • Formings	• Light production workers • Assembly workers • Foundry workers
Manufacturing Assembly	• Assembly lines (100 nationwide) located in high solar isolation regions	• Assembly lines (10 nationwide)	• Assembly line workers
Shipping	• Interstate—within the state • Overseas	• Interstate—from central locations to 50 states • Overseas	• Truckers • Railroad personnel • Shippers
Dealers Sales Finance Service Warranty	• Community based • House calls • Arranged with lender • Residential neighborhoods • Local repair	• Community based • Showrooms • Arranged with company • At local garages • Local repair	• Sales force • Bankers • Service technicians

Designed by Dr. Barry Butler, Vice-President of SERI

Chairman RANGEL. Mr. Payne.

Mr. PAYNE. Thank you very much, Mr. Chairman.

Mr. Shaw, I was very interested in your testimony. I have a lot of timber in my district. Mr. Kopetski intended to be here, but he has been detained and has not yet come back.

You mention in your testimony that many woodlot owners are re-evaluating the use of their land and are converting it to other uses. Could you provide the committee with some data on how much timberland is now being converted to other uses?

Mr. SHAW. Well, it continues to be a significant amount each year. Specific numbers I don't have with me in my information here, but, basically, we are doing more on small acreage is what it boils down to, through research and so forth. And a lot of it has shifted to companies that have a vested interest in developing those resources for manufacturing purposes.

The small private landowner is the one that has geared back because of loss of incentives, and that is basically where the largest loss is occurring.

Mr. PAYNE. I think you mentioned 72 percent of all the commercial timberland is owned by small——

Mr. SHAW. Right, by independent, nonpublic agencies, nonagency, nonpublic land. That would include corporate land also.

Mr. PAYNE. So that is all private corporation?

Mr. SHAW. Right. Most areas in our region in the south, that translates into—of the three-fourths of the land base that is owned by nonpublic entities, approximately two-thirds of that is owned by nonindustrial owners. That is just a general, overall overview of the south.

Mr. PAYNE. It is my own observation that timberlands are being converted, and we need to understand that from a public policy perspective as we look down the road. If there is information that you might provide the committee——

Mr. SHAW. I would be happy to.

Mr. PAYNE [continuing]. We would appreciate that very much.

[The following was subsequently received:]

SHAW, MCLEOD, BELSER AND HURLBUTT, INCORPORATED

FOREST RESOURCE CONSULTANTS

BARTOW S. SHAW, JR.
FRANK A. MCLEOD, III
ROY E. BELSER
BORIS HURLBUTT
PAUL E. KLAPTHOR

407 N. PIKE ROAD E. • POST OFFICE BOX 487
SUMTER, SOUTH CAROLINA 29151

803-773-5461
FAX 803-773-4248

WALTERBORO OFFICE
250 BELLS HIGHWAY
P.O. DRAWER 770
WALTERBORO, SC 29488
803-549-2507
FAX 803-549-1719

GEORGETOWN OFFICE
117 SCREVEN STREET
P.O. BOX 2287
GEORGETOWN, SC 29442
803-527-1814
FAX 803-527-1814

July 14, 1993

Ms. Janice Mays, Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, DC 20515

FAX: 1-202-225-2610

Dear Ms. Mays:

In response to questions by Representatives Payne and Kopetski during my testifying on behalf of H.R. 960 on June 24, I refer to a recent compilation of data by the U.S. Forest Service showing the timberland area in the United States for the years 1992, 1987, 1977, 1962, and 1952.

In 1987, the first year affected by the Tax Reform Act of 1986, farmer-owned timberland in the United States was 95,791,000 acres. In 1992, the farmer-owned timberland acreage was 82,484,000 acres, a 13.9 percent drop from 1987.

I will be pleased to elaborate on the report and provide additional information if needed. However, as I understood the questions, this should provide the information requested. Thank you for the opportunity to provide this support for our position.

Yours very truly,

Bartow S. Shaw, Jr.

BSSjr/pmb

cc: Mr. Phil Ufholz

Mr. PAYNE. Ms. Zimmerman and Mr. Sklar, I wanted to just comment on my great and esteemed colleague Mr. McDermott's bill.

I, too, am very interested in using renewable sources. I do have some concerns about how this might be paid for.

I have received some correspondence from a number of organizations very concerned about section 302, which would eliminate the ability of publicly owned utilities to issue tax-exempt bonds for construction, upgrading, maintenance, and operation of energy facilities which use coal, oil, and nuclear fuel.

These organizations are ones such as the American Public Gas Association, Public Power Association, American Public Works Association, the Council of Infrastructure Financing Authorities, the Government Finance Officers Association, National Association of Counties, National Association of State Auditors and Comptrollers and Treasurers, National Association of State Treasurers, National Association of Towns and Townships, National Governors Association, National League of Cities, National School Boards Association, and, additionally, on section 303, which I know a little more about, the National Rural Electric Cooperative Association. Section 303 calls for the repeal of the tax-exempt status of rural electric cooperatives.

In the economic package that we are now working on, the rural electric cooperatives have already been affected to the extent that the subsidy for their loans has been reduced and in many cases eliminated.

So, while I support the concept that we need to find ways to provide some incentives for what it is that you are attempting to do, I do have concerns about sections 302 and 303 and would like to enter these letters into the record if I might.

Chairman RANGEL. Without objection.

[The information follows:]

AIRPORTS COUNCIL INTERNATIONAL -- NORTH AMERICA
AMERICAN PUBLIC GAS ASSOCIATION
AMERICAN PUBLIC POWER ASSOCIATION
AMERICAN PUBLIC WORKS ASSOCIATION
COUNCIL OF INFRASTRUCTURE FINANCING AUTHORITIES
EDUCATION FINANCE COUNCIL
GOVERNMENT FINANCE OFFICERS ASSOCIATION
NATIONAL ASSOCIATION OF COUNTIES
NATIONAL ASSOCIATION OF STATE AUDITORS, COMPTROLLERS & TREASURERS
NATIONAL ASSOCIATION OF STATE TREASURERS
NATIONAL ASSOCIATION OF TOWNS AND TOWNSHIPS
NATIONAL GOVERNORS ASSOCIATION
NATIONAL LEAGUE OF CITIES
NATIONAL SCHOOL BOARDS ASSOCIATION

June 23, 1993

Honorable Dan Rostenkowski
U.S. House of Representatives
2111 Rayburn House Office Building
Washington, D.C. 20515

Dear Congressman Rostenkowski,

We, the above organizations representing state and local governments and their officials, are writing to express our opposition to Section 302 of H.R. 2026, the Renewables and Energy Efficiency Incentives Act of 1993, introduced by Congressman Jim McDermott (D-WA). Section 302 strikes a serious blow to state and local autonomy by eliminating the ability of publicly owned electric utilities to issue tax-exempt bonds for construction, upgrading, maintenance and operation of energy facilities which use coal, oil or nuclear fuel. We understand the House Ways and Means Committee has scheduled a hearing for June 24 on this issue.

Congressman McDermott proposes to place restrictions on tax-exempt bonds as a revenue offset for tax incentives for renewable energy sources and conservation measures. While promoting renewable energy and energy conservation is a noble objective, the bill's impact on energy policy would be far outweighed by what amounts to a significant policy change in the tax treatment of state and local municipal bonds. Section 302 of the bill represents yet another attempt to limit the kinds of governmental functions which may qualify for tax-exemption.

Tax-exempt financing has traditionally been extended to all activities undertaken by state and local governments, so long as the facilities are owned and operated by the government and benefits are provided to all citizens. Restricting the issuance of tax-exempt bonds by state and local governments will significantly

increase the cost of providing public facilities, particularly infrastructure facilities. State and local governments are ultimately responsible for providing these public services, therefore, decisions about these public facilities are best left at the state and local levels.

There is simply no justification for distinguishing between electricity service and other state and locally owned services for which governmental bonds are issued. Thus, if it can be argued that public power should not be allowed to issue tax-exempt bonds for coal, oil, and nuclear powered facilities (because the federal government does not want to promote this type of energy generation), what is to prevent the same argument from applying to the issuance of tax-exempt bonds for schools that are heated by oil, or mass transit systems that utilize gasoline powered buses?

Although each of our organizations fully support the goals of energy efficiency and conservation, the means by which the McDermott bill achieves these ends would seriously compromise the historical sovereignty of states while providing, at best, a marginal change in the use of coal, oil and nuclear fuel for energy production and a minimal amount of additional federal revenues.

We urge you to oppose section 302 of H.R. 2026 the Renewables and Energy Efficiency Incentives Act of 1993.

National Rural Electric
Cooperative Association

1800 Massachusetts Avenue, N.W.
Washington, D.C. 20036-1883
Telephone: (202) 857-9500

Statement of

Bob Bergland
Executive Vice President
National Rural Electric Cooperative Association

for the Record of
U. S. House of Representatives
Committee on Ways and Means
Subcommittee on Select Revenue Measures

Regarding H.R. 2026,
The Renewables and Energy Efficiency Incentives Act of 1993

June 24, 1993

EXECUTIVE SUMMARY: H.R. 2026, the Renewables and Energy Efficiency Incentives Act of 1993, Section 303, calls for the repeal of tax exempt status for rural electric cooperatives. Rural electric cooperatives currently qualify for tax exemption under Section 501(c)(12) of the Internal Revenue Code of 1986. Their exemption is based on the way cooperatives are organized, not on what services they provide. The Internal Revenue Service administers very strict tests to determine tax exempt status of a cooperative under Section 501(c)(12) including democratic control, operation at cost, return of capital credits based on margins and a severely limited amount of activity conducted with nonmembers of a cooperative. The exemption under 501(c)(12) is granted on a case-by-case basis and has decades of case law behind it. The National Rural Electric Cooperative Association must oppose H.R. 2026 as long as Section 303 addressing rural electric cooperatives remains in the bill.

Mr. Chairman, distinguished members of the Subcommittee, my name is Bob Bergland and I am executive vice president of the National Rural Electric Cooperative Association (NRECA). I submit this statement for the hearing record on behalf of the nation's approximately 1,000 not-for-profit, consumer-owned rural electric systems that provide central station electric service to more than 25 million people in 46 states.

Rural electric lines span 70 percent of the nation's land mass to serve 10 percent of the nation's population. These rural electric systems continue to face the traditional obstacles that make serving rural areas difficult — rugged terrain, harsh weather and distance.

Another obstacle is rate disparity. Seventy percent of rural electric systems have higher rates than their neighboring utilities. Part of that rate disparity is attributable to the higher per-consumer investment in plant necessary to serve in rural areas. In addition, rural electric systems serve primarily residential loads — two-thirds residential as compared to two-thirds commercial and industrial loads served by investor-owned and municipally-owned utilities.

Rural electric systems are consumer-owned, and organized as not-for-profit cooperatives. Everyone who receives service is a member-owner of the rural electric system, and, in the event that revenues exceed expenses, those excess revenues are returned to consumers in the form of capital credits. There is no profit.

Because of the way they are organized, rural electric systems qualify for tax exemption under Section 501(c)(12) of the Internal Revenue Code. To qualify for this exemption, rural electric systems must undergo rigorous examination by the Internal Revenue Service (IRS).

Qualification for this exemption is based on several factors. First, the organization must be democratically controlled. Typically, this requirement is met through the principle of one-member, one-vote. Rural electric cooperatives meet this prerequisite, as every consumer has the right to vote in board elections and in other matters concerning the affairs of the cooperative. As well, co-ops must operate at cost, and must return capital credits based on margins. Finally, organizations that qualify for 501(c)(12) exemption must conduct a large majority of their business with members: the IRS places severe restrictions on how much business a cooperative may conduct with nonmembers. Cooperatives must annually prove that 85 percent or more of their business is conducted with members.

The exemption under Section 501(c)(12) is granted on a case-by-case basis, and has decades of case law standing it. The system of regulation, statute and case law which underpins rural electric systems' tax exemption works because it ensures that not-for-profit cooperatives are subject to oversight by the IRS, Congress and the courts. The current system provides a level of certainty which allows prudent business planning by cooperatives for their members.

H.R. 2026, the Renewables and Energy Efficiency Incentives Act of 1993, contains a number of incentives which would seem to promote the use of renewable resources and the wise use of energy.

Rural electric cooperatives are committed to the wise use of energy, and many rural electric systems utilize integrated resource planning to achieve reliable, affordable electric service in rural areas. For example, cooperatives in at least four Western states (Colorado, Wyoming, Nebraska and Kansas) are using or investigating the use of photovoltaic cells to provide power to remote locations for use in livestock watering facilities, television signal repeaters, electric fencing and static protection for pipelines. In addition, one generation and transmission cooperative, Tri-State G&T Association, Inc. of Denver, Colorado, is in negotiations on a joint venture which would construct a 60 to 70 megawatt wind farm in Wyoming, from which Tri-State would receive 10 megawatts of power.

However, H.R. 2026 also contains a provision, in Section 303, that is based apparently on a misunderstanding of rural electric cooperative operations and has no bearing on the cost to the federal government of rural electrification.

Rural electric systems, like all electric utilities, receive federal assistance. However, that federal assistance comes in the form of loans from the Rural Electrification Administration (REA), an agency of the United States Department of Agriculture, not from provisions of the Internal Revenue Code. Hence, the federal cost of the rural electric program comes from an annual appropriation to cover the difference between the cost of money to the government and the rate at which it is loaned to rural electric borrowers. The Subcommittee on Agriculture of the House Committee on Appropriations recently approved an appropriation for rural electric direct loans of $61 million which would fund a loan level of $725 million. That cost is a reduction from the Fiscal Year 1993 appropriation of $117 million in subsidy cost due to changes drafted by the House Committee on Agriculture and approved by the full House of Representatives in the budget reconciliation bill.

As a result of President Clinton's call for deficit reduction, the rural electric cooperatives have agreed to the changes included the House-passed version of budget reconciliation which would restructure the REA lending program and reduce the federal assistance to rural electric borrowers. We fully expect the full Senate to approve similar cuts in its version of budget reconciliation. We agreed to these changes in order to target government assistance to the neediest of cooperative systems. Furthermore, we agreed to these cuts in the full knowledge that none of the subsidies provided to other segments of the electric utility industry were facing punitive changes in budget reconciliation.

The revocation of tax-exempt status in Section 303 of H.R. 2026 would not affect federal revenues because not-for-profit cooperatives by definition have no profit to tax. However, revocation of 501(c)(12) would "upset the applecart" of statute, regulation and case law, imposing additional accounting burdens on rural electric systems, their consumer-members and additional oversight burdens on the IRS.

Furthermore, we have serious doubts about the efficacy of providing "energy conservation and renewable energy incentives" only to investor-owned utilities and their customers while curtailing the ability of consumer-owned power systems (whether municipally- or cooperatively-owned) and their consumers to exercise similar incentives.

NRECA must vigorously oppose H.R. 2026 as long as Section 303, addressing rural electric cooperatives, remains in the bill. We further urge your opposition to the inclusion of Section 303 as a revenue offset for the tax incentives embodied in H.R. 2026. Section 303 is not energy-related tax policy; it deals with the structural organization of businesses. As such it is an inappropriate addition to the incentives in H.R. 2026.

I will be happy to respond to any questions members of the Subcommittee may have.

Mr. PAYNE. I just wanted to state my concern about this bill, and if you have any comment on that I would appreciate it.

Ms. ZIMMERMAN. One comment, actually. One of the paragraphs I eliminated, running out of time, dealt with the fact that it is, of course, always easier to provide new subsidies than to eliminate old subsidies, but that it is clear from the picture that I described of Federal energy subsidies that real progress is going to have to involve reducing subsidies and eliminating subsidies that are already in place. I think that is something we need to face up to.

Mr. SKLAR. I don't want to put any words in the mouth of the great and esteemed Congressman from the State of Washington, but I believe the intent of that title was, as Mary Beth Zimmerman said, was to basically show that there are subsidies that throw the market toward conventional energy, and I think it was to highlight that more than anything else.

From my industry's point of view—my association's point of view, we consider the utilities sector, rural co-ops, investor-owned utilities and public power to be our strategic partners and the other renewable technologies as well. And from running a trade association the many years I have and being a married man I learned it is a lot easier to get things you want using carrots than sticks.

And I expect that the appropriate role here was to highlight the bias in the Tax Code, but I think the goal really is to allow the utilities sector to make right choices. And so what we are really looking for is to not punish utilities in any way shape or form but to encourage them to make some risks on environmentally sound technology. So that is how we would prefer to take a look at that.

Mr. PAYNE. I agree with and applaud that goal. I hope that it would be possible for all these organizations to work together to accomplish it.

Mr. SKLAR. It is the solar industry's intent to do that.

Mr. PAYNE. Thank you very much.

Thank you, Mr. Chairman.

Chairman RANGEL. The Chair recognizes the great and esteemed Congressman——

Mr. KOPETSKI. Thank you, Mr. Chairman.

Chairman RANGEL. From Washington. I am terribly sorry. We have more than one great and esteemed member of this committee, but the first great and esteemed member will be Congressman McDermott.

Mr. MCDERMOTT. Thank you, Mr. Chairman.

I would like to read—or put a statement in the record because last year the Ways and Means Committee added to the National Energy Policy Act several provisions encouraging the use of renewable energy, energy efficiency, mass transit and alternative fuels. These provisions enjoyed bipartisan support and were widely acclaimed as some of the most progressive steps taken in the act in the direction of new and sustainable energy.

Last winter, I invited several energy experts, some of whom are testifying here today and are somewhat flowery in their comments, to discuss with my staff how to build on last year's accomplishment. The consensus of the group was that energy efficiency and renewable energy technologies were poised to play a vital role in this country's economic energy future. Before such a change can

happen, the United States needs to change its Tax Code which strongly favors investment in conventional and polluting fuels.

It is really out of that effort that a discussion paper came, which I will distribute soon to the members of the committee, and H.R. 2026, a bill which is in this hearing today.

I would like to comment on section 302 since it has come up, which repeals tax-exempt financing for the construction of electric generating facilities fueled by coal, petroleum and nuclear power. This provision was not intended to affect the upgrade, maintenance or operation of existing facilities.

I have invited the American Public Power Association on several such occasions to sit down with my staff to address the concern in this area. Seattle City Light, which is my own public utility, so I have no interest in offending public utilities, has indicated its desire to work on this provision. I hope that others will join.

Last year, I helped secure an expansion of tax-exempt financing to allow public utility districts in Washington State to improve fish passage on their hydroelectric dams, and I am a supporter with Rich Neal on the $15 million private use restriction on public power bonds in this session, so I am a strong supporter of municipal finance. But I think that we do need to look at the code and see how the code drives energy choices in this country.

[The prepared statement follows:]

Statement for the Record
by Rep. Jim McDermott (D-WA)
Subcommittee on Select Revenues
June 24, 1993

STATEMENT

Last year, the Ways and Means Committee added to the National Energy Policy Act several provisions encouraging the use of renewable energy, energy efficiency, mass transit, and alternative fuels. These provisions enjoyed bipartisan support, and were widely acclaimed as some of the most progressive steps taken in the Act in the direction of a new and sustainable energy future.

Last winter, I invited several energy experts, some of whom are testifying before you today, to discuss with my staff how to build on last year's accomplishment. The consensus of the group was that energy efficiency and renewable energy technologies were poised to play a vital role in this country's economic and energy future. Before such a change can happen, however, the U.S. needs to alter a tax code which strongly favors investment in conventional and polluting fuels. Out of that effort grew a discussion paper which I will distritute soon to all members of the Committee, and H.R. 2026, the Renewables and Energy Efficiency Incentives Act of 1993, a bill before the Committee in today's hearing. I look forward to working with the Committee and other members of Congress in accomplishing this transformation of the tax code.

Before closing, I would like to comment on Section 302 of my legislation, which repeals tax exempt financing for the construction of electric generating facilities fueled by coal, petroleum, or nuclear power. This provision is not intended to affect the upgrade, maintenance, or operation of existing facilities. I have invited the American Public Power Association on several occasions to sit down with my staff to address its concern in this area. Seattle City Light has indicated its desire to work on this provision and I hope others will join us.

Last year I helped secure an expansion of tax exempt financing to allow public utility districts in Washington State to improve fish passage on their hydroelectric dams. This year, I am a cosponsor of legislation introduced by Congressman Neal which repeals the $15 million private use restriction on public power bonds.

Although I am a strong supporter of municipal tax exempt financing, I differ with my colleagues in public power when they argue that the federal government has no right to restrict the usage of this tax subsidy. A recent study found that, from 1980 - 1989, nearly 90 percent of capital

spending resulting from public power bond issues benefitted the coal and nuclear industries. By comparison, the combined total for wind, solar, and energy efficiency amounted to less than 1 percent of all public power bond issues. (emily—from marybeth's report. verify the figures with her. a total in dollars might add to it here.)

Finally, Section 302 raises no new revenue. Joint tax estimates that any revenue freed up by the restrictions in section 302 would be used by municipalities for other purposes. Under my bill, public utilities can continue to build coal and nuclear plants, but investors must pay the full cost of these facilities. Any revenues saved by this provision, will then be available to municipalities to spend as they choose, on low-income housing, environmental cleanup, new port facilities, or perhaps, on energy efficiency and renewable energy. (leave Seattle City Light out. we have no letter in hand. they serve us better not dragged too far into the middle of this.)

Federal tax policy plays a key role in shaping investment decisions, and without a change in the tax code, our energy future will look much like our energy past. A few logical changes to the tax code will help ensure that we simultaneously achieve two of our most important national goals: a healthy environment and a vibrant economy.

June 23, 1993

The following organizations support H. R. 784, "The Energy Efficiency and Conservation Act of 1993," which was introduced by Congressman McDermott. We urge the House to include H. R. 784 in an appropriate legislative vehicle.

Energy efficiency is a critical resource for meeting America's future energy needs at minimum cost and with minimum environmental impact. Congress recognized this last year when it largely exempted energy efficiency rebates from taxation in H. R. 776, "The Comprehensive National Energy Policy Act."

H. R. 784 continues the policy established in H. R. 776. It ensures that the cost of this energy resource is not arbitrarily increased by clarifying that it is our national tax policy to allow utilities to expense, not capitalize, expenditures for utility energy efficiency programs.

The Alliance to Save Energy
American Gas Association
Cincinnati Gas and Electric
Consolidated Edison Company
Duke Power
Duquesne Light Company
Edison Electric Institute
The Empire District Electric Company
Entergy Services
Jersey Central Power & Light
Long Island Lighting Company
Metropolitan Edison
Montana Power
NARUC
New England Electric Service
New York State Electric and Gas
Niagara Mohawk Power Company
Northern States Power Company
Oklahoma Gas & Electric Company
Pacific Gas and Electric Company
PacifiCorp
Penelec
Portland General Electric Company
PSI Energy, Inc.
Puget Sound Power and Light Company
St. Joseph Light & Power
San Diego Gas and Electric Company
Southern California Edison Company
Texas Utilities Services, Inc.
Union Electric Company
United Illuminating Company
Washington Water Power
Wisconsin Electric Power Company
Wisconsin Public Service Corporation

**The companies in italics have been added since letters were sent to members of the House Ways and Means Committee*

ALLIANCE TO SAVE ENERGY * FRIENDS OF THE EARTH
NATURAL RESOURCES DEFENSE COUNCIL

June 25, 1993

Honorable Jim McDermott
1707 Longworth House Office Building
U.S. House of Representatives
Washington, D.C. 20515

Dear Representative McDermott:

We would like to commend you for developing The Renewables and Energy Efficiency Incentives Act of 1993 (H.R. 2026). The bill represents a coherent effort to reform our nation's tax code by rejecting the current practice of subsiding mature, polluting energy sources at the expense of efficiency and clean, emerging technologies. This legislation will push the nation in a new direction, toward a future which values environmental quality and economic vitality.

We are grateful for your past support of environmentally friendly tax measures, particularly your efforts last year in the Ways and Means Committee to include a package of environmentally friendly tax measures in the National Energy Policy Act. H.R. 2026 is a natural outgrowth of those earlier efforts to rationalize policy for development of energy efficiency and renewable energy sources while eliminating subsidies for dirty and dangerous sources.

As you know, the tax code powerfully influences the investment and research decisions made by companies and individuals. By removing obsolete subsidies for conventional energy sources, H.R. 2026 will reduce a major obstacle to developing cleaner energy alternatives. In addition, providing targeted incentives for emerging technologies is good policy to improve our country's economic competitiveness in the emerging global markets and to assure that future growth will not exact a high cost in environmental degradation.

Once again, we thank you for your efforts in this crucial area. We look forward to working closely with you to advance your legislation.

Sincerely,

Dawn Erlandson

Dawn Erlandson
Director, Tax Policy Project
FRIENDS OF THE EARTH

On behalf of:

Dan Lashof
Senior Scientist
NATURAL RESOURCES DEFENSE COUNCIL

Mary Beth Zimmerman
Senior Program Manager
ALLIANCE TO SAVE ENERGY

Mr. McDERMOTT. I would like to ask just one question of Ms. Zimmerman if the chairman would give me a moment.

Everyone asks for—anyone who asks for subsidies assures us it will create jobs. How can you create jobs by removing subsidies?

Ms. ZIMMERMAN. Very good question. The key here is productivity and, in particular, productivity gains that are possible and available by allowing new and emerging industries to compete in the open market.

Productivity gains—when we promote—when we remove the barriers to the commercialization of energy efficiency, renewable energy resources, we do two things. One is we improve productivity and manufacturing with industries using less energy and using it more effectively. That promotes our products overall, makes our industry more competitive overall.

Secondly, the energy efficiency and renewable energy industries are more labor intensive than many of the energy supply industries, and this allows the creation of—a net job creation as these industries emerge. It simply puts us at a more competitive advantage when we allow the industries to compete on an equal footing in the marketplace.

Mr. McDERMOTT. How can we be sure that the general tax provisions, when you put them in, will not go to the old industries rather than things that you want to do? How do you do that in a general tax provision?

Ms. ZIMMERMAN. I think it is something that we need to be careful about because the tax provision can affect energy choices even if it doesn't have energy in the title or the text.

Provisions that make capital investment cheaper overall are used very extensively in the energy supply sector, and that means our taxpayer dollars are being used to help make it cheaper to produce conventional energy resources. And so the language of the provisions has to carefully stipulate which capital investments are eligible for that kind of treatment.

Chairman RANGEL. The Chair will recess. Did you vote?

Mr. HOAGLAND. I did.

Chairman RANGEL. Very good. Then, Mr. Kopetski, we have got 7 minutes to vote. It is your decision as to whether or not you want to inquire at this time, but, meanwhile, Mr. Hoagland will chair while we go vote.

Mr. KOPETSKI. Thank you.

Chairman RANGEL. Before I leave, Mr. Brewster, by unanimous consent, will enter his statement in the record for this panel as will Congressman Matsui without objection.

[The prepared statements follow:]

Statement of Mr. Brewster (OK)

Mr. Chairman, I want to welcome Ms. Lazenby to the Committee. I appreciate her coming here from Tennessee to share her expertise with us.

I also want to express my strong support for the legislative agenda of the Independent Petroleum Association of America. Along with my colleagues, Mr. Jefferson and Mr. Andrews, I have co-sponsored legislation to provide incentives to encourage domestic oil and gas exploration and production. A healthy domestic oil and gas industry is vital to our national security.

Mr. Chairman, I urge you and all of our colleagues to review carefully Ms. Lazenby's proposals and join me in supporting them.

STATEMENT OF THE HONORABLE ROBERT T. MATSUI
MEMBER OF CONGRESS
FIFTH DISTRICT, CALIFORNIA
REGARDING ENERGY CONSERVATION REBATES

June 24, 1993

Mr. Chairman: last year this Committee reaffirmed its commitment to energy conservation by adding language to the Energy Policy Act of 1992 to provide residential customers with an exclusion from gross income for the value of any subsidy provided by an electric utility for the purchase or installation of energy efficiency equipment. Conservation rebate programs are a popular and proven means of advancing the use of energy conservation products. The action taken by this Committee revised and expanded the conservation rebate program originally authorized under the National Energy Conservation Policy Act, which expired on June 30, 1989.

The new rebate program has a broader scope than the original and applies to rebates for air conditioners, refrigerators, and many other energy efficiency measures. However, the program has a gap that I believe must be addressed. The old exclusion expired in June 1989; the exclusion applies to rebates issued after 1992. Thus, residential customers that received utility rebates or subsidies from July 1, 1989 to December 21, 1992 must include the value of those subsidies in their calculation of gross income.

This has come as a surprise to a number of residential rate payers in my district and elsewhere in the nation. For certain customers, the economic impact of this is substantial and -- I fear -- could undermine the intent of this Committee by proving to be a disincentive to participation in future rebate programs.

Therefore, today I am proposing that the Committee approve a narrow amendment to the provisions we adopted last year to make retroactive to June 30, 1989 the exclusion from taxable income for energy conservation rebates and subsidies. I think my colleagues will agree that this simple change will close the gap in the program and help ensure the success of utility energy conservation programs.

The Joint Tax Committee has recently provided me with an estimate of the cost of this proposal. I intend that the cost of this proposal is fully covered by an appropriate offset. Thank you.

Mr. KOPETSKI. Mr. Chairman, I have about 2 or 3 minutes of questions for Mr. Shaw, then I will have to leave and vote quickly and come back. This way, I think the panel will be finished, and we can move to the next panel, unless you have questions, of course. I am trying to dig myself out of a hole that you missed that I did—did do to myself here. I am trying to be accommodating and timely.

Mr. Shaw, you are from the southeast?

Mr. SHAW. That is correct.

Mr. KOPETSKI. I am from the northwest. I guess it is important to note that the reforestation issue isn't just localized to the northwest, is that correct?

Mr. SHAW. Absolutely. It is a national issue.

Mr. KOPETSKI. What State do you live in?

Mr. SHAW. South Carolina.

Mr. KOPETSKI. Do they have a Forest Practices Act?

Mr. SHAW. They do. Voluntary.

Mr. KOPETSKI. It is all voluntary so there is no requirement that you, by State law, reforest the lands?

Mr. SHAW. That is correct.

Mr. KOPETSKI. And Mr. Payne was asking about trying to find some empirical data to show that we are losing some of these lands?

Mr. SHAW. That is correct.

Mr. KOPETSKI. Do you think there are any studies done out there?

Mr. SHAW. That data is available. It escapes me. Six months ago, I could have given it to you off the top of my head, but I don't have it with me.

Mr. KOPETSKI. Could you furnish that to the committee staff?

Mr. SHAW. I would be happy to.

Mr. KOPETSKI. Have you heard of the spotted owl?

Mr. SHAW. A little of it.

Mr. KOPETSKI. You don't have any?

Mr. SHAW. We have the redheaded woodpecker.

Mr. KOPETSKI. Do they just land on public lands?

Mr. SHAW. No, they have difficulties discerning which is which.

Mr. KOPETSKI. On private lands as well?

Mr. SHAW. That is correct.

Mr. KOPETSKI. This is a Federal law, the Endangered Species Act?

Mr. SHAW. That is correct.

Mr. KOPETSKI. So you have the situation where people have been growing trees on their own land, their private property, and all of a sudden a little critter comes along and wants to make babies, and so you can't cut down.

Mr. SHAW. That is right.

Mr. KOPETSKI. You can't cut down your trees, can you?

Mr. SHAW. That is correct.

Mr. KOPETSKI. In fact, it becomes very restricted in terms of how you can use that land?

Mr. SHAW. That is correct.

Mr. KOPETSKI. Is this not another incentive to walk away from the timber industry?

Mr. SHAW. There are quite a few incentives. That creates a difficulty, that is correct.

Mr. KOPETSKI. What has happened to the price of lumber in the last 6 months?

Mr. SHAW. Well, it has been on a roller coaster. It has gone up and down and continues to go up and mostly up.

Mr. KOPETSKI. Mostly up.

Mr. SHAW. There have been some adjustments down, but mostly up.

Mr. KOPETSKI. So is it safe to say if you want to build a house it costs a heck of a lot more?

Mr. SHAW. That is right.

Mr. KOPETSKI. Just because of the price of lumber?

Mr. SHAW. That is correct.

Mr. KOPETSKI. A significant difference?

Mr. SHAW. Significant.

Mr. KOPETSKI. Does this include public housing projects or single family dwellings?

Mr. SHAW. Right.

Mr. KOPETSKI. Everything.

This has been very helpful. I think it is important that the committee understand that this is a national issue that we are talking about, that this directly impacts the price of houses, and that all of this isn't within the control—in fact, there has been adverse impact by the Federal Government, you know, good or bad. Regardless of what you think of the Endangered Species Act and endangered species, it is having an impact on private landowners.

Mr. SHAW. That is correct.

Mr. KOPETSKI. Thank you.

Thank you, Mr. Chairman.

Mr. SHAW. I would like to add, Mr. Kopetski, that—I think you weren't here—we feel like you are great and honorable for introducing that bill, so I will clarify that issue. We thank you and Congressman Wyden for introducing H.R. 960, and we support it strongly.

Mr. KOPETSKI. Thank you very much. I will be sure to tell Mr. Rangel that.

Mr. HOAGLAND [presiding]. Are there any other comments any panelists would like to make?

Ms. LAZENBY. I would like to make a comment about the marginal properties, marginal stripper properties, producing properties.

We made a proposal, H.R. 1024—the Independent Petroleum Association has made a proposal about which I testified earlier, and the administration on Tuesday through Secretary—Assistant Secretary Leslie Samuels opposed the proposal. And I would just like to make a comment on the rationale for that opposition.

We believe they just don't understand marginal production, and we are also a bit confused because President Clinton, in written responses to questions, has made statements that he understood the arguments of those in the domestic oil and gas business who believe we should not shut any marginal wells which are still producing oil but may not be economically feasible to keep operating.

President Clinton said, I would certainly consider various solutions to the problems, including tax credits. And yet the Treasury

Department comes out—they make the statement that marginal properties were provided substantial tax advantages in recent tax legislation.

The industry did receive some tax advantages, but I am talking about marginal producing properties. Most of these properties produced very little or no taxable income. Thus, the net income limitation which still exists produces a percentage depletion allowance for many stripper wells that is about 2 percent.

In addition, the net income limit—I mean, the net income limitation produces no regular tax benefits, so the removal of the alternative minimum tax has no benefit, so we have not received significant benefits, marginal producers.

In addition, he states that we have seen no evidence that tax liability is currently acting as a barrier to production on these properties. That simply is not true. It is not a question of tax liability. We don't have much tax liability.

What we need is a tax policy that creates economic incentive much like some of the other people who have been testifying here today. A production tax credit would allow us to raise capital, to add reserves and to keep jobs from being lost and to keep imported oil from increasing.

So that is what we are asking for. And Secretary O'Leary has been traveling around the country saying that she wants to work with the industry and to develop policies and tax policies. She definitely said it was on the table.

So we are a little confused at Treasury's statement, and I think we can provide you with additional information, if needed, to do that. And I would just also like to say that in our statement it is a revenue neutral, so our proposal would be revenue neutral.

Mr. HOAGLAND. OK. Well, thank you, Ms. Lazenby.

I appreciate all of you coming and testifying today. This will conclude panel number four.

Mr. HOAGLAND. And now let me invite those members of panel five to the table.

Gentlemen, I think we would like to get this underway as quickly as we can. Why don't we begin with Mr. Smith, Anthony Smith, Assistant Controller with Southern California Edison.

Do I understand, Mr. Smith, you are testifying on behalf of the Natural Resources Defense Council as well?

Mr. SMITH. Yes.

Mr. HOAGLAND. And the other groups that are listed here at the beginning of your statement?

Mr. SMITH. That is correct.

Mr. HOAGLAND. So Southern California Edison is testifying on behalf of the Natural Resources Defense Council, Alliance to Save Energy as well as itself on this issue?

Mr. SMITH. Yes.

Mr. HOAGLAND. That has to be a first.

STATEMENT OF ANTHONY L. SMITH, DIRECTOR OF TAXES, SOUTHERN CALIFORNIA EDISON CO., ALSO ON BEHALF OF 26 OTHER UTILITY AND INTERESTED ORGANIZATIONS

Mr. SMITH. OK, thank you.

Mr. Chairman and members of the subcommittee, my name is Tony Smith, and I am director of taxes for Southern California Edison Co., which is located in Rosemead, Calif.

I am here today on behalf of my company and 21 other major electric and gas utilities, as well as the Natural Resources Defense Council, Alliance to Save Energy, and the National Association of Utility Regulatory Commissioners. I am also testifying on behalf of the Edison Electric Institute and the American Gas Association, which are trade associations representing electric and gas utilities throughout the Nation.

These electric and gas utility regulators and environmental groups are united in their support of H.R. 784, the Energy Efficiency and Conservation Act of 1993, which was introduced by Congressman McDermott. This bill will affirm longstanding tax policy and resolve a current controversy concerning the tax status of conservation program expenditures as described in more detail in my written testimony.

Ever since our industry began these programs in the 1960s, utilities have deducted energy conservation expenditures in the year incurred, consistent with longstanding tax policy. Many companies are now facing selective pressure from IRS agents to capitalize these expenditures and, unless the law is clarified to prevent this unfair pressure, our Nation's electric and gas utilities will be forced to curtail these programs which are an effective means of achieving energy efficiency and conservation.

Environmental and consumer groups, State utility regulators and industry alike, recognize that energy conservation programs are a vital way to promote energy conservation, more efficient use of existing energy resources and improve the quality of our environment.

The utility companies listed in our written testimony, as well as hundreds of other electric and gas utilities, have dedicated considerable funds for conservation programs and services. These programs assist customers in achieving more efficient use of existing energy resources. Conservation expenditures include energy efficiency audits, education programs which promote efficient use of energy, insulation and weatherization materials, and subsidies and rebates paid to utility customers for installation of efficient lighting, appliances and other energy efficient products.

It should be noted that the energy efficient products purchased in conjunction with these programs are owned by customers and not utilities.

Until recently, the tax law was clear that utilities could deduct the full cost of energy conservation expenditures in the year incurred as ordinary and necessary business expense. In fact, in 1991 the IRS specifically addressed the tax treatment of these expenditures and concluded that energy conservation expenditures are currently deductible.

In spite of this history, some IRS auditors have recently attempted to disallow current deductions for these expenditures based on the stretched interpretation of case law involving entirely different matters. These auditors have asserted that such expenditures must be capitalized and recovered over an extended number of years.

These efforts are clearly inconsistent with the current law. Further, this attempt at changing longstanding tax policy works against our Nation's energy policy by jeopardizing these conservation programs.

If this interpretation is allowed to stand, the cost of energy conservation programs will be unfairly and dramatically increased. The increased costs of these programs will cause utilities and regulators to curtail conservation program contributions in order to avoid passing on the increased tax costs to utility customers.

H.R. 784 would put a stop to this developing IRS audit practice. The bill clarifies and makes explicit longstanding tax policy.

The Tax Code amendment includes a clear rule stating that utilities may continue to deduct the full cost of energy conservation expenditures in the year incurred. If enacted, the legislation would help ensure that utilities are able to maintain their commitment to fund conservation programs that reduce customer bills and improve the environment and stabilize our country's overall energy use. Passage of this bill would send a clear message that sound tax policy is not at odds with our Nation's energy and environmental policies.

Before I close, I would like to comment on a portion of the testimony of the American Public Power Association. I understand that in their testimony they made a statement about how they failed to see why a 13-year retroactive provision encourages energy conservation.

H.R. 784 is a clarification of existing law. Utilities have relied on this law and have based rates charged to utility customers on this understanding. It would be unfair and punitive to allow the IRS to retroactively tax utilities on a recently contrived interpretation of the law. The 1980 effective date is required to assure that utilities are not unfairly and unequitably penalized and to resolve the issue quickly through a clarification of the law rather than through protracted litigation which could extend for years.

Mr. Chairman, on behalf of environmental and consumer groups, utility commissions and industry alike, I urge you to adopt H.R. 784 at the earliest possible opportunity.

Thank you and the entire subcommittee for holding this hearing and for the opportunity to express our opinions here today. I would be pleased to answer any questions that you may have.

Mr. HOAGLAND. Thank you, Mr. Smith.

[The prepared statement follows:]

Testimony of

NATURAL RESOURCES DEFENSE COUNCIL
ALLIANCE TO SAVE ENERGY
NATIONAL ASSOCIATION OF REGULATORY UTILITY COMMISSIONERS
BOSTON EDISON COMPANY
CENTRAL MAINE POWER COMPANY
COMMONWEALTH EDISON COMPANY
CONSOLIDATED EDISON COMPANY
ENTERGY SERVICES, INC.
LONG ISLAND LIGHTING COMPANY
MONTANA POWER COMPANY
NEW ENGLAND ELECTRIC SYSTEM
NEW YORK STATE ELECTRIC & GAS CORPORATION
NORTHEAST UTILITIES
NORTHERN STATES POWER COMPANY
OKLAHOMA GAS & ELECTRIC COMPANY
PACIFIC GAS & ELECTRIC COMPANY
PACIFICORP
PORTLAND GENERAL ELECTRIC COMPANY
PUGET SOUND POWER & LIGHT COMPANY
SAN DIEGO GAS & ELECTRIC COMPANY
SOUTHERN CALIFORNIA EDISON COMPANY
TEXAS UTILITIES SERVICES, INC.
UNITED ILLUMINATING COMPANY
WASHINGTON WATER POWER COMPANY
WISCONSIN ELECTRIC POWER COMPANY
EDISON ELECTRIC INSTITUTE
AMERICAN GAS ASSOCIATION

by Anthony L. Smith
Director of Taxes
Southern California Edison Company
Rosemead, CA

Before the

SUBCOMMITTEE ON SELECT REVENUE MEASURES
COMMITTEE ON WAYS AND MEANS
UNITED STATES HOUSE OF REPRESENTATIVES

June 24, 1993

Introduction

Chairman Rangel and Members of the Subcommittee on Select Revenue Measures, my name is Anthony L. Smith, and I am the Director of Taxes for Southern California Edison Company ("SCE") of Rosemead, California. I am here today on behalf of my company, and the 26 utilities and interested organizations listed above from all over the United States.

We appreciate the opportunity to submit testimony concerning H.R. 784, the Energy Efficiency and Conservation Act of 1993 (the "Bill"). The Bill would affirm longstanding tax policy which allows utilities to deduct the full cost of their energy conservation expenditures in the year incurred and, therefore, would help ensure that our nation's electric and gas utility companies can continue their efforts to promote energy efficiency and conservation.

Environmental and consumer groups, state utility regulators, and industry alike generally recognize energy conservation as an option for assisting customers in using energy more efficiently, improving the environment, and reducing consumer costs. Companies such as ours expend considerable funds for conservation programs and services designed to assist customers in utilizing energy more efficiently. Any products purchased in conjunction with these programs are owned by the customers. Examples of

conservation expenditures include: energy efficiency audits; education programs promoting efficient use of energy, insulation and weatherization materials; and subsidies and rebates for installation of efficient lighting, appliances and other energy efficient products.

Since these energy conservation programs were initiated in the early 1960s, electric and gas utilities have deducted these expenditures in the year incurred for tax purposes. As recently as 1991, the IRS reinforced this policy, concluding in a Technical Advice Memorandum that energy conservation expenditures are allowable as a current deduction. See TAM 9128010 (March 29, 1991).

Some IRS auditors, however, have recently attempted to modify this longstanding policy by disallowing current deductions for energy conservation expenditures and directing that these expenditures be recovered over a number of years. We provide below a more detailed synopsis of the recent confusion regarding the tax treatment of energy conservation expenditures and why the IRS efforts to require capitalization of conservation expenditures are not only clearly inconsistent with current law but also contrary to our Nation's energy policy. We also discuss why a legislative reaffirmation of the longstanding tax treatment of energy conservation expenditures is warranted.

The Current Conflict of Interpretation

Under section 162 of the Internal Revenue Code of 1986, as amended (the "Code"), taxpayers may take a deduction for "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business." Code section 263(a) disallows a deduction for "[a]ny amount paid out for new buildings or permanent improvements or betterments made to increase the value of any property or estate."

Many courts have focused on whether expenditures like conservation expenses should be considered section 162 deductions. It is clear that in determining whether a payment is a capital expenditure or a deductible expense, the courts must review the facts. Southland Royalty Company v. United States, 582 F.2d 604, 609 (Ct. Cl. 1978), cert. denied, 441 U.S. 905 (1978); Manufacturers Hanover Trust Company v. United States, 312 F.2d 785, 788-789 (Ct. Cl. 1963), cert. denied, 375 U.S. 880 (1963); United States v. Times Mirror Company, 231 F.2d 876, 879 (9th Cir. 1956). The cost of acquiring or constructing buildings, equipment, machinery, fixtures, or other items that have a useful life extending substantially beyond the taxable year are considered capital expenditures. See Treas. Reg. § 1.263(a)-2(a). Having a useful life extending beyond the taxable year remains a "prominent, if not predominant" characteristic of a capital expenditure. Seligman v. Commissioner, 796 F.2d 116, 119 (5th cir. 1986).

A recent line of cases has confused the issue of how to determine if an expenditure is capital. The Supreme Court held in 1971 that a payment, which creates or enhances what is essentially a separate and distinct asset, constitutes a capital expenditure if it has an ascertainable value. Commissioner v. Lincoln Savings & Loan Association, 403 U.S. 345, 354 (1971).

Some IRS agents have suggested that Lincoln Savings and its progeny support a position that conservation expenditures create a "separate and distinct asset", namely, the right to receive "whatever benefits" accrue from these programs. Under this position, the value of the purported "asset" is equal to the delayed or avoided cost of new generating plants or purchase of power displaced through conservation of energy.

In order to reach this position, certain IRS agents have focused on the fact that if the energy conservation programs were not in place, utilities would be obliged to incur costs by adding generating capacity. This position is an oversimplification because additional generating capacity required to service customers in fact results in more income to the utility from generated electricity. Further, capital expenditures and financing expenses incurred by a regulated utility to add new generating capacity contribute to the utility's regulatory capital and are included in the utility's ratebase on which it is entitled to an investment return from its ratepayers. To the extent conservation displaces the need to add new generating capacity, future utility income is usually diminished.

More recently, interpretations of the Supreme Court's decision in Indopco, Inc. v. Commissioner, 112 S. Ct. 1039 (1992), have created additional confusion as to how to determine if an expenditure is capital. In Indopco, the Court held that a corporate taxpayer was required to capitalize certain investment banking fees and other acquisition-related expenses incurred in connection with its acquisition by another company, where the transaction produced significant benefits to the taxpayer that extended beyond the tax year at issue. Some IRS agents have interpreted Indopco to argue that utility conservation expenses have benefits that will extend into future years and, therefore, should be capitalized.

This argument is predicated on an interpretation of Indopco that would require capitalization of any expenditure that creates a "substantial future benefit that is not incidental." Such an interpretation is misguided. Unless a company acts contrary to its own interests, every expenditure creates some type of benefit. If Indopco were read to apply to all expenditures that create any "future benefit" to a taxpayer, numerous different expenditures that have historically been deductible would now be required to be capitalized, such as advertising.

IRS officials have indicated in public statements that Indopco does not modify existing law or establish a bright-line test for determining when various expenditures should be capitalized and when they should be deducted. Moreover, the IRS has ruled that there are instances in which a "future benefit" exists, but to which Indopco may not be properly applied. See Rev. Rul. 92-80, 1992-39 I.R.B. 7. Clearly, this indicates that Indopco was not intended to create a new basis for disallowance of business expenses. IRS agents should not be permitted to claim the existence of a spectral "future benefit" to utilities and shift the burden to the taxpayer to prove that this "future benefit" does not extend beyond the current taxable year.

Also, even if one were to assume, for purposes of argument, that expenditures must be capitalized in all instances in which some future benefit exists, the Code still does not require utility companies to capitalize conservation expenditures. Such expenses do not necessarily provide a current or a future benefit to utilities or their shareholders. "Future benefits" from a utility company's conservation programs concededly exist, including the maintenance of lower costs to customers; however, those benefits generally accrue to a utility company's customers and not to its shareholders.

Any purported "benefits" to utilities are uneven, temporary, experimental, subject to customer operations and management, and subject to change as markets for energy efficiency products and services are transformed over time and, thus, do not meet the criteria for capitalization. For example, it is the customer who makes the decision to purchase and operate the conservation measure. The utility does not have any control over the lasting effect of conservation program expenditures made on behalf of its customers.

In addition, it has been a well established tax policy to allow current deductions for expenditures incurred to reduce current costs. From the utility's perspective, conservation expenditures reduce current costs in two principal ways: they reduce total energy production, and they result in more efficient use of existing generating resources. This reduction in cost of production is transferred to customers in the form of lower utility bills.

The fact that some utilities may be required by their regulatory commissions to defer recovery of conservation expenses and are allowed to earn a return for ratemaking purposes does not preclude a current deduction for tax purposes. The IRS has consistently held that regulatory recovery of utility costs, with or without a return, does not create an asset for tax purposes. Rate regulation is designed to provide a service to customers at a reasonable cost, while assuring the financial health of the utility. See Rev. Rul. 87-117, 1987-2 C.B. 61. In particular, deferred recovery mechanisms are designed by regulators to spread the rate recovery of conservation expenditures over an extended period for the benefit of ratepayers, and do not change the character of the underlying expense for tax purposes.

A Legislative Solution is Needed to Clarify Existing Law

The current confusion concerning the state of law applicable to conservation expenditures creates uncertainty which threatens the viability of conservation programs. Unless the Code is clarified, IRS agents will be encouraged to challenge the deduction of energy conservation program expenditures which will unfairly and unwisely increase the after tax cost of these programs, resulting in higher costs to utility customers and curtailment of conservation activity. The current situation leads to substantial uncertainty, increases conservation costs and causes a hesitancy to engage in programs which are in the best interests of the customers, the environment and national energy policy. Utilities could also face back tax liabilities for deductions taken in previous years through reliance on well-established tax principles.

Furthermore, the status quo would penalize utilities and customers for conducting conservation programs that are mandated by regulatory commissions and would be at cross-purposes with our Nation's energy policy. The Energy Policy Act of 1992 ("EPAct") and its predecessors, including the landmark Clean Air Act, established energy efficiency and environmental preservation as matters of federal government policy. The EPAct sets out an energy policy designed to meet future energy requirements for the Nation. Among other provisions, this legislation encourages increased emphasis on conservation and alternative energy resources. Energy efficiency programs in existence before the EPAct represented a significant dedication of resources on the part of electric utilities toward conservation goals. In addition, the Bill would conform the Code to the current Administration's public policy agenda.

H.R. 784 would put a stop to the developing IRS audit practice. It clarifies and makes explicit longstanding tax policy allowing utilities to continue deducting the full cost of energy conservation expenditures in the year incurred and maintaining commitments to programs that reduce customer bills, improve the environment, and stabilize our country's overall energy use. The Bill reaffirms existing law and sends a message that sound tax policy is not at odds with our Nation's energy and environmental policies. To do otherwise would increase the cost of conservation expenditures so that many programs would be uneconomical and our customers would be the losers, as well as the environment.

Mr. Chairman, on behalf of environmental and consumer groups, utility commissions, and industry alike, I urge you to adopt H.R. 784 at the earliest possible opportunity. Thank you and the entire Subcommittee for holding this hearing and for the opportunity to express our opinions here today. I would be pleased to answer any questions you may have.

Mr. HOAGLAND. Mr. Vaughn.

STATEMENT OF ERIC VAUGHN, PRESIDENT AND CHIEF EXECUTIVE OFFICER, RENEWABLE FUELS ASSOCIATION

Mr. VAUGHN. Thank you, Mr. Chairman.

On behalf of the Renewable Fuels Association, the national trade association for the domestic ethanol industry, I want to thank you and the other members of this committee for the opportunity to be here today to testify or offer testimony in support of at least two of the key provisions of H.R. 2026.

My name is Eric Vaughn, and I am the president and chief executive officer of the Renewable Fuels Association. We represent over 75 companies across the country manufacturing fuel grade ethanol. Virtually all of those companies are manufacturing ethanol today from grain, almost all of that from corn.

On behalf of the members of the Renewable Fuels Association, I want to express my support for Congressman McDermott's legislative initiative, the Renewables and Energy Efficiency Act of 1993.

We ought to be doing as much as we possibly can to support, promote, to develop our alternative renewable energy resources. Unfortunately, our estimation of this initiative is that, if it passed in its presentation, we would actually see a decline in the level of production and use of renewable alternative energy resources, primarily because of the principal funding mechanism employed.

The intent of the initiative could not be clearer. However, the outcome, if the tax incentive made available today for ethanol blended products should be reduced, would be to substantially undermine and undercut the domestic ethanol industry.

Two years ago, the House Ways and Means Committee actively supported and worked to promote the extension of that tax incentive. On the basis of that extension, many new plants were built and operational.

Congressman Hoagland's own State of Nebraska just announced the largest single new ethanol production facility in the country in 5 years. Cargill has announced plans for over a 100 million gallon ethanol production facility in Blair, Nebr. But the development potential of the domestic ethanol industry and the exciting opportunities afforded from the extension of that incentive just 2 years ago are also being experienced in the Caribbean basin.

Just before coming down here today to testify before this esteemed panel, I sat and listened to the House Ways and Means Committee's Subcommittee on Trade discuss and debate various Caribbean basin initiatives. There are over 72 million gallons of ethanol production in the Caribbean basin, built and operated to produce ethanol for domestic U.S. utilization.

In the State of New York we are building facilities to make ethanol out of waste paper. In fact, just earlier today an RFP was issued by the Sanitation Department of the State of New York to offer contract opportunities for the processing of over 1,600 tons a day of waste paper into fuel grade ethanol.

The opportunities are incredibly exciting. The potential for this industry is only just recently becoming a reality with the passage of the clean air laws and the dramatic increase in utilization of these fuels.

To change this important tax incentive opportunity at this critical moment in the industry's development would be an unbelievably destructive move. We would estimate that virtually every ethanol production facility in America and the Caribbean basin would cease to operate.

These facilities cannot manufacture the alternative fuels in competition with oil-based, petroleum-based, and in many cases import-based alternative fuels in this marketplace, but that is changing. This industry is developing and is investing its resources to assure enhanced production and market development opportunities into the next decade.

We estimate that with technological changes, new feed stock opportunities and energy efficiency developments we can see the day when ethanol will compete effectively with all oxygenated fuels. In fact, the U.S. Department of Agriculture has estimated that by the year 2000 ethanol plants will operate in a financially stable and technologically advanced way to work in concert with the industry without the need for subsidies. That is a very optimistic goal and objective, but one that we are committed to working toward.

The Department of Agriculture's Economic Research Service recently issued a report that suggested precisely what the ethanol industry needs to compete. The ERS report also discusses what the oil companies need to take advantage of the ethanol tax incentive because, ultimately, this is a tax incentive available only to oil companies, those companies who choose to blend and manufacture an ethanol blended product.

Mr. Chairman, at this critical time in the domestic ethanol industry's development we would find it unbelievably ironic and very destructive for the ethanol tax incentive to be reduced as proposed by this legislative proposal.

I would like to conclude with a statement, actually a letter to Congressman Dick Durbin from the President of the United States recently. He said, and I quote the President:

> Our Nation's policy toward ethanol has suffered from a lack of decisiveness in past years. The on-again, off-again nature of this policy has limited our ability to create an infrastructure capable of integrating ethanol into the array of fuels available. A policy should be established that looks forward and looks to the long term, thereby providing certainty to our farmers, our refiners and our distributors

President Clinton couldn't be more accurate on this point. He is absolutely on target. We are faced with enormous opportunities and feel that we can fulfill those opportunities with the incentive structure in place and keeping it in place and keeping it operational.

I thank you very much for the opportunity to be here. I look forward to answering any of your questions. Thank you.

Mr. KOPETSKI [presiding]. Thank you, Mr. Vaughn.

[The prepared statement and attachment follow:]

Testimony of

Eric Vaughn
President and Chief Executive Officer
Renewable Fuels Association

Before the

Committee on Ways and Means
Subcommittee on Select Revenue Measures

Regarding

H.R. 2026, the Renewables and Energy Efficiency Act of 1993

Washington, D.C.

June 24, 1993

On behalf of the members of the Renewable Fuels Association, the national trade association for the domestic ethanol industry, I would like to express my appreciation to the Chairman, and the Members of the Subcommittee, for this opportunity to present testimony on H.R. 2026, the Renewables and Energy Efficiency Act of 1993. The goal of H.R. 2026, i.e., making wind and solar energy more competitive by extending and expanding tax incentives for their use, is commendable. This country needs to do everything possible to encourage the increased production and use of domestically-produced renewable energy. We are therefore very concerned by the bill's funding mechanism which, if enacted, could result in a smaller percentage of this country's energy needs being satisfied by renewables, not more.

In order to fulfill the clear intent of H.R. 2026, we would respectfully suggest the following modifications. First, the provision contained in Section 301 to reduce the federal excise tax exemption for ethanol from 5.4 cents to 3.5 cents per gallon should be deleted. If enacted, this provision would drive a stake through the heart of the domestic ethanol industry, stopping all expansion plans, closing existing facilities, and preventing this industry from becoming the vital alternative mobile fuel source this Committee intended when it extended the tax incentive program for ethanol blends just two and a half years ago. If necessary, other acceptable revenue options should be found.

Second, we would urge the Subcommittee to amend H.R. 2026 to include similar renewable energy tax incentives included in the Renewable Fuels Incentives Act of 1993, S. 465, introduced this year by Senator Tom Daschle. In short, S. 465 has three basic provisions. First, it allows the alcohol fuel blender credit to offset the alternative minimum tax (AMT). Second, it provides a tax credit for biodiesel fuels. Finally, the bill would partially repeal the requirement under IRS Code section 87 that the blender credit be included in gross income.

With these two modifications, H.R. 2026 would receive the strong and enthusiastic support of the Renewable Fuels Association, and would go a long way toward reducing our nation's growing dependence on imported energy while increasing U.S. economic and environmental security.

BACKGROUND

The United States fuel ethanol industry has a current operational production capacity of over 1.2 billion gallons per year. More than 40 ethanol manufacturing facilities located in 20 states are operating today. Domestic ethanol producers have invested over $2.5 billion in private sector resources to construct modern and efficient ethanol production facilities.

In 1992 alone, approximately one billion gallons of ethanol were produced from more than 400 million bushels of grain. As a direct result of ethanol production, it is estimated that farm income increased $750 million, federal farm program costs were reduced by nearly $600 million, and crude oil imports fell by 42 million barrels.

Today, ethanol/gasoline blend sales represent over 8 percent of all motor fuels sold in the U.S. While ethanol was originally used as a gasoline extender, capable of stretching tight gasoline supplies, ethanol is currently marketed as a high quality octane booster capable of improving automobile performance by adding 3 octane points with every 10% ethanol blend. Ethanol blends are approved under the warranties of all 19 domestic and foreign automobile manufacturers marketing vehicles in the U.S. In fact, in recent years auto manufacturers such as General Motors and Chrysler have recommended the use of oxygenated fuels because of their clean air benefits.

In recent years, the remarkable growth of the ethanol industry has been directly related to its increasing use as a weapon against air pollution for the nation's 90 carbon monoxide and ozone non-attainment cities. Ethanol has a number of air quality benefits. First, because the oxygen content of an ethanol blend is almost twice that of other oxygenated fuels, its ability to reduce CO levels is greater than any alternative oxygenated fuel. The use of ethanol blends will reduce motor vehicle emissions of CO by 25 - 30 percent. Ethanol blends will also reduce emissions of exhaust hydrocarbons and carbon dioxide emissions. In addition, recent analysis indicates that ethanol blended fuels can reduce the formation of urban ozone. Finally, ethanol is an effective and safe replacement for dangerous aromatic octane enhancers in gasolines today.

The 1990 Clean Air Act Amendments require the use of oxygenates such as ethanol in all CO non-attainment areas and severe ozone non-attainment areas that use reformulated gasolines. EPA has concluded that the use of oxygenates in these fuels will dramatically reduce mobile source pollution. The result of these provisions will be tremendous marketplace opportunities for ethanol, and a dramatic improvement in air quality.

In the future, we expect ethanol may also be marketed as an ether based oxygenate - ethyl tertiary butyl ether (ETBE). ETBE has the potential of opening major new markets for ethanol because it can be blended at refineries and shipped through common carrier pipelines. In addition, ETBE can actually reduce the volatility of the base gasolines with which it is blended. While ETBE is only available commercially on a very limited basis for testing purposes, it promises to be a valuable supplemental market to 10% ethanol blends and a natural competitor to the ether based oxygenates available today - methyl tertiary butyl ether (MTBE) and tertiary amyl methyl ether (TAME).

ETHANOL'S ROLE IN U.S. PUBLIC POLICY

The ethanol blending industry makes major contributions not only to the environment, but also to American agriculture, balance of trade, and energy security in a manner that cannot be rivaled by other oxygenates.

The Environment. The addition of oxygen to gasoline significantly reduces exhaust emissions. As a result, "oxygenates" -- such as ethanol and its principal alternative, methyl tertiary butyl ether ("MTBE") -- play a vital part in the implementation of the Clean Air Act's oxygenated gasoline and reformulated fuels programs.

The oxygenated gasoline program requires the use of gasoline with a minimum oxygen content in certain urban areas as a means of reducing carbon monoxide ("CO") emissions. EPA has recently announced that the first season of operation of the oxygenated gasoline program was a resounding success:

> [T]he new, oxygenated fuel program ... has resulted in sharp declines of harmful carbon monoxide emissions...[P]reliminary air quality monitoring data ... show only two days when the carbon monoxide health standard was exceeded as compared to 43 days the year before, a 95 percent reduction in the number of days exceeding the standard.[1]

The reformulated gasoline program will also depend on oxygenates to reduce the exhaust component of volatile organic compound emissions ("VOCs") and toxic emissions. Projected supplies of alternative oxygenates are insufficient to meet the demands of the two programs. In the absence of the ethanol industry, it is therefore very unlikely that sufficient oxygenates would be available to meet the requirements of both programs.

Moreover, ethanol can be an important weapon in the response to global warming. The production of ethanol consumes carbon dioxide and yields oxygen to the atmosphere, recycling atmospheric carbon, whereas the use of other oxygenates such as MTBE releases fossil fuel carbon, thereby actually adding to the atmospheric load of heat-trapping gasses. Ethanol also emits 35 percent less carbon dioxide for the same amount of fuel energy, decreasing greenhouse gas effects.[2] Overall, ethanol can significantly reduce carbon dioxide emissions attributable to motor vehicle fuels.

Agriculture. Since 1979, approximately 2 billion bushels of corn have been used to produce more than 5 billion gallons of high-quality, high-performance fuel ethanol. Thus, for more than a dozen years, ethanol has been expanding economic growth in our rural communities; reducing government farm program costs; and, creating highly nutritious food and feed co-products for our agricultural sector and the American consumer.

More than 90 percent of the ethanol used in motor vehicle fuel is produced from corn, with one bushel of corn yielding approximately two and one-half gallons of ethanol. The continued use of ethanol from 1990 through 1998 would reduce farm subsidies by $1 billion dollars per year, and would increase farm output by $2.5 billion per year by the year 2000.[3] These developments would create more than 1 million jobs and net the Federal budget between $3.9 and $4.8 billion. At least half of other oxygenates will be imported, and fail to provide these cost benefits.

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[1] EPA Notes to Correspondents, March 11, 1993.

[2] "Greenhouse Gas Emissions from Corn-Based Ethanol Production and Vehicle Use," Acurex Project 6586, Acurex Corporation, June 1990.

[3] U.S. Government Accounting Office, Alcohol Fuels: Impacts from Increased Use of Ethanol Blended Fuels, July, 1990.

Balance of Trade. The growing trade deficit is one of the major public policy problems confronting our nation. The development of a viable domestic fuel ethanol industry has been one of the few positive factors improving the U.S. balance of trade. Recent statistics show dramatic and continuing increases in the amount of imported crude oil. As stated by the Senate Committee on Energy and Natural Resources:

> Under business as usual, the United States, dependent on imports for 42 percent of its oil in 1990, is headed for levels of dependence of 60 to 75 percent in the next two decades.[4]

Ethanol production and use reduces the outflow of funds caused by these imports by displacing the crude oil. It has been reported that the use of ethanol-enhanced fuel reduces the U.S. annual oil import bill by almost $1 billion. In contrast, over half of the alternative oxygenates to ethanol are imported.

In addition, because only the starch of corn is used to produce ethanol, the corn proteins, vitamins, and minerals are salvaged from the process and concentrated in a residual product that can be used for a variety of purposes, including export of protein feed, protein gluten meal, and edible corn oil, further decreasing the U.S. balance of payments.

Energy Security. The displacement of foreign crude oil and oxygenates also serves the nation's efforts to achieve energy independence. As discussed by the U.S. Senate Committee on Energy and Natural Resources:

> Increased dependence on oil imports means, inevitably, increased dependence on the nations of the Persian Gulf. The potential for economic disruption and war in the event of interruptions in Persian Gulf supplies will increase. . . .
>
> If the projected United States dependence on Persian Gulf oil materializes, not only will the probability of economic disruption and war increase, but policies available to the United States to deal with political turmoil in the world, including the Mideast, will be affected.[5]

The use of domestically produced ethanol, however, means a gallon for gallon reduction in dependence on foreign oil. According to the Congressional Research Service:

> [I]t is widely agreed among petroleum economists that virtually all of any decrease in U.S. refinery input of crude oil or in petroleum product end-use comes at the expense of imported petroleum. Thus, while it would be difficult to track and estimate, it can be assumed that any net reduction in petroleum use as a result of the combined effects of price change and the replacement of gasoline by alcohol would ultimately result in a barrel-for-barrel decrease in imports of crude oil or of gasoline.[6]

Further, much of imported MTBE will be imported from OPEC countries. MTBE is manufactured from natural gas. In the

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[4] S. Rep. No. 72, 102nd Cong., 1st Sess. (1991) at 201.

[5] S. Rep. No. 72, 102d Cong., 1st Sess. at 204.

[6] "Analysis of Possible Effects of H.R. 2031, Legislation Mandating Use of Ethanol and Methanol in Gasoline", Congressional Research Service, November 1987, at 44.

aftermath of the Gulf War, to increase dependence upon natural gas supplies in the Middle East is an undesirable option.

ETHANOL TAX INCENTIVE PROGRAM

In 1990, the Congress voted overwhelmingly to extend the existing federal tax incentive program through the end of the decade, to allow the fledgling domestic ethanol industry to mature, and to promote the economic, environmental, and energy security benefits cited above.

Prior to Congressional consideration of the Omnibus Budget Reconciliation bill in 1990, which included provisions of H.R. 3906, the Energy and Environmental Security Act of 1990 to extend ethanol tax incentives, the U.S. General Accounting Office (GAO) released a report on the agricultural and budgetary impacts of the ethanol tax incentive program. The GAO Report verified conclusions reached by several previous industry and government studies which stated that the federal alcohol fuel tax incentive program actually saves the government monies in reduced farm program costs and increased rural income.

The GAO concluded that with more ethanol produced, the demand for and price of corn would increase, causing fewer farmers to participate in farm support programs, fewer farmers to default on their commodity loans, and decrease deficiency payments and acreage diversion program payments. The report showed reductions in federal outlays from farm support programs that would average about $900 million and $1.4 billion per year, respectively, under a low-growth and high-growth scenario. According to GAO, "the cumulative outlay reductions over the 8-year period would total about $7.4 billion and $11.4 billion, respectively."

Importantly, both GAO's growth simulations assumed significant reductions in target prices over the eight year period. GAO ran a separate simulation of its high-growth model, however, using target prices fixed at their 1990 level. That scenario showed farm program reductions averaging about $3.5 billion per year with cumulative reductions totalling more than $28 billion!

Acknowledging that continuation of the excise tax exemption for ethanol-blended fuels was necessary to stimulate the growth and development in the industry necessary to meet the increased ethanol production assumed in both the low-growth and high-growth scenarios, GAO also calculated projected losses to the government resulting from reduced gasoline excise tax revenues. Based on a simple calculation of projected gallons less the exemption, GAO estimated that the low-growth and high-growth simulations would further reduce tax revenue by an annual average of $440 million and $813 million, respectively.

GAO concluded, however, that the average net impact to the federal government resulting from the federal ethanol program would be a savings of between $460 million and $610 million. Over the eight year period, the government would save between $3.7 billion and $4.7 billion.

In addition to a net savings to the government, the GAO Report concluded that the increased demand for corn used in the production of ethanol would increase farm income substantially. Under the high-growth scenario, more than 1.3 billion bushels of corn wold be processed into 3.3 billion gallons of ethanol, 8 million tons of protein-rich corn gluten feed for poultry, and more than 1.9 million tons of gluten meal used to feed dairy cows. As a result of this added-value for corn, the average corn prices over the low and high growth simulation periods increased about 12 cents and 22 cents per bushel, respectively.

In short, the ethanol tax incentives create jobs, open new markets for feed grains that are by-products of the ethanol production process, reduce dangerous emissions of carbon monoxide and ozone, decrease our dependence on imported oil, and save money for the federal government.

H.R. 2026, THE RENEWABLES AND ENERGY EFFICIENCY INCENTIVES ACT OF 1993

As noted above, the Renewable Fuels Association strongly supports the increased use of all renewable energy resources. As such, we support the intent of H.R. 2026, but we believe if passed in its current form, H.R. 2026 will actually result in less renewable energy being used, not more. This will occur because one of the funding mechanisms contained in Title III would dramatically reduce the current tax incentive for domestically produced renewable ethanol.

Currently, there are plans for more than a billion gallons of increased ethanol production capacity in various stages of development. (See attached list of U.S. Ethanol Facilities in the Planning Stage.) Announcements of increased production capacity are being made with increasing frequency. Just last week, Cargill announced a decision to proceed with a 100 million gallon facility in Blair, Nebraska, which would make that company the second largest ethanol producer in the country. In addition, significant investment and development has occurred in the Caribbean Basin as a direct result of this Committee's efforts two years ago to assure production from this region may enter the U.S. market duty-free. Finally, Department of Energy research has made great strides in making the production of ethanol from cellulose possible in the very near term. One such facility has been planned for Great Falls, New York.

While not all of these proposed facilities may ever come to fruition, they reflect the tremendous potential for growth in the domestic ethanol industry and the opportunity for economic stimulus across rural America with ethanol produced from grain, throughout the CBI region with ethanol produced from sugar cane, and in our nation's cities as ethanol is produced from municipal solid waste.

Importantly, the viability of each of these proposed new plants and existing facilities is dependent upon the continuation of the current excise tax structure. Reducing the current incentive by more than a third (5.4 cents to 3.5 cents per gallon) would eliminate ethanol as a competitive oxygenate, threatening the implementation of Clean Air Act programs, increasing our dependence on imported energy, worsening our balance of trade, and devastating many rural economies.

As a result, the Section 301 provision to reduce the ethanol tax incentive must be dropped. The current ethanol tax incentive has proven itself to be an extremely cost-effective means of expanding the use of renewable energy resources. To abrogate that incentive now, after having extended it just two years ago, would be particularly ironic given the intent of this legislation, and shortsighted in any event.

The bill could be further improved by expanding its scope beyond renewable solar, wind and geothermal to include renewable fuels such as ethanol and its derivatives. Senator Tom Daschle has introduced S. 465, the Renewable Fuels Incentives Act of 1993. The intent of this legislation is to assure that the existing tax incentives for ethanol are usable for its derivatives such as ETBE and to create a new incentive for biodiesel.

Specifically, S. 465 allows the alcohol fuel blender credit to offset the alternative minimum tax (AMT). This provision was

included in the Senate version of the energy bill which passed last year. Second, it applies the existing blenders credit to biodiesel fuels, defined as a liquid derived from biological materials (other than alcohol) for use in compression ignition engines. Finally, the bill would partially repeal the requirement under IRS Code section 87 that the blender credit be included in gross income. These provisions would greatly expand the market opportunities for renewable ethanol into markets where imported methanol, produced by mideast oil refiners from flared natural gas, has retained a significant economic advantage.

It is important to note that we believe the proposed changes can be accommodated without the need for additional revenues. While we have not been privy to the cost or revenue estimates of the various provisions included in H.R. 2026, we believe that sufficient revenues should exist from the other revenue increases included in Title III to justify the modifications to the bill which we have suggested. If this is not the case, we would be glad to work with the Members of the Subcommittee to identify other appropriate revenue offsets.

CONCLUSION

In a letter to Congressman Dick Durbin in January discussing his support for expanded market opportunities for ethanol, then President-elect Clinton observed:

> Our nation's policy toward ethanol has suffered from a lack of decisiveness in past years. The "on-again, off-again" nature of this policy has limited our ability to create an infrastructure capable of integrating ethanol into the array of fuels available. A policy should be established that looks to the long-term, thereby providing certainty to our farmers, refiners and distributors.

President Clinton's observation is absolutely on target in describing the challenge which has faced the domestic ethanol industry in the past, and his words are instructive to this Subcommittee as it considers measures to increase the use of renewables. This is a critical time in the development of the domestic ethanol industry, and approving a measure which reduces the current incentive would send a potentially irrevocable "off-again" signal to the industry. We do not believe that is the intent of this Congress, this Subcommittee, or this bill, and we would be pleased to work with the Members of the Subcommittee and staff to fulfill the promise of H.R. 2026 -- the increased production and use of renewable energy.

Thank you.

U.S. ETHANOL FACILITIES IN PLANNING STAGE

Currently, there are plans for more than a billion gallons of increased ethanol production capacity in various stages of development. While not all of these may ever come to fruition, they reflect the tremendous potential for growth in the domestic ethanol industry. In total, there are 52 different projects underway in 22 different states.

State	Type	Number	Potential Capacity *
Arkansas	new	1	25
California	expansion	2	10
Illinois	expansion	3	235
Iowa	new	1	20
	expansion	1	100
Kansas	expansion	1	4.5
Kentucky	re-open	2	29
Louisiana	re-open	4	82
Michigan	re-open	1	5
Minnesota	new	7	91
	expansion	1	3.5
Missouri	new	2	20
Montana	new	2	35
Nebraska	new	3	150
	expansion	1	13
New Mexico	re-open	5	5.3
New York	new	1	15
North Carolina	new	2	120
North Dakota	new	3	25
	expansion	2	28
Oregon	new	1	20
South Dakota	new	1	15
	expansion	1	4
Tennessee	re-open	1	20
Texas	new	1	20
	re-open	1	15
Washington	new	1	1
Wisconsin	new	1	15
Wyoming	new	1	2.5
Total		52	1050

* million gallons per year

Mr. KOPETSKI. We will hear from Mr. Gary Elliott, president of the National Wood Energy Association. Good afternoon.

STATEMENT OF GARY ELLIOTT, PRESIDENT, NATIONAL WOOD ENERGY ASSOCIATION

Mr. ELLIOTT. Thank you for this opportunity to testify.

The National Wood Energy Association, known as NWEA, is a trade association of the direct combustion biomass industry, whose members include equipment manufacturers, project developers, material handling, equipment suppliers and dealers, woodlot owners and electric utilities.

NWEA urges the Ways and Means Committee to expand the 1.5 cent biomass production tax credit established in the Energy Policy Act of 1992 to include biomass that is harvested on a sustainable basis and pure wood wastes. Unless pure wood wastes, agricultural residues, and forest products are eligible for the production credit, the economics will not permit sustainable crops because waste feedstocks will remain less expensive. Therefore, NWEA urges the expansion of the definition so that waste feedstocks will be used, and that will open the way for sustainable grown biomass.

Biomass contributes more electric and thermal energy than any other renewable except hydropower. Yet the Federal Government's policies and programs do not reflect the importance of biomass's contribution to our energy mix. The Energy Policy Act of 1992 excludes biomass energy derived from wood waste, forest and agricultural residues from qualifying for the 1.5 cent biomass production credit. As over 98 percent of all biomass electricity is generated from waste, particularly wood waste, these exclusions make the production credit all but useless for the biomass industry.

The following correction to the Energy Policy Act Section 45 will allow the tax credit to be used as it was intended, by including biomass that is harvested on a sustainable basis, not purely grown:

Closed loop biomass includes all growing matter harvested on a sustainable basis in compliance with State and local government regulations incorporating timber harvested via sustainable forest-management practices, forest residues, waste wood and agricultural residues. Biomass-electric facilities using mixed wastes, municipal solid wastes, tires or the harvesting of old growth forests, defined as wood stands more than 35 years old, in no case will be eligible for the production credit.

Although some facilities take advantage of stored energy found in these byproducts, their exclusion from the tax credit obstructs the growth of the industry. This obstruction represents a most unfortunate short-sightedness. At a time when we are trying to reduce United States demand for expensive, potentially insecure foreign energy and when the need for new job-creating industries is high, we cannot afford to ignore the opportunity that biomass represents.

The biomass energy industry creates jobs directly as well as indirectly, giving a boost to a number of related industries through a ripple effect. Three studies performed with the Department of Energy's Regional Biomass Energy Program all support this view, and if the results of these analyses are extrapolated to the United States as a whole, it is estimated that using biomass for energy

would produce several billion dollars in income annually and help to sustain hundreds of thousands of industrial wood jobs.

These benefits, when looking at the economic impact of both residential and industrial wood combustion, total 414,000 new jobs and $8.3 million of new income across the country.

Expanding the biomass production tax credit would allow the credit to do what it was meant to do in the first place, which is to jump-start an industry with many environmental and economic benefits. Looking at the big picture, it becomes obvious that expanding the credit to include biomass energy from waste wood and forest and agricultural residues would pay back handsomely. It would significantly decrease pressure on our rapidly filling landfills, prevent pollution and provide secure jobs.

Equally important, it would pave the way for the development of a biomass industry based on sustainable crops, which will not happen until the reserves of waste are depleted.

In conclusion, a sustainable biomass program would multiply the benefits already being provided by the current biomass industry. Since new growth in industries such as forestry and logging would be involved, job creation would spiral upward. Depending on the assumptions and programs, the U.S. biomass industry can create up to 350,000 jobs within the next 20 years alone. The potential to create wealth in areas of the country previously locked out of the possibility of real economic growth is astounding.

The United States has been the industrial and technological leader of the world for decades. In the current increasingly competitive world market it is essential that we do not pass over promising emerging industries simply because they are new and different. A growing biomass industry will be a shot in the arm for the economy, not to mention its many environmental benefits that will protect Americans' health and ensure that our children have the resources necessary to maintain this country's position of leadership. Thank you.

Mr. KOPETSKI. Thank you, Mr. Elliott.

[The prepared statement follows:]

STATEMENT OF GARY ELLIOTT, VICE PRESIDENT,
NATIONAL WOOD ENERGY ASSOCIATION

INTRODUCTION

The National Wood Energy Association (NWEA) is the trade association of the direct combustion biomass industry whose members include equipment manufacturers, project developers, material handling, equipment and dealers, wood lot owners, and electric utilities. NWEA urges the Ways and Means Committee to expand the 1.5 cent biomass production tax credit established in the Energy Policy Act of 1992 to include biomass that is harvested on a sustainable basis and pure wood wastes. Unless pure wood wastes, agricultural residues, and forest products are eligible for the production credit, the economics will not permit sustainable crops because waste feedstocks are less expensive. Therefore, NWEA urges the expansion of the definition so waste feedstocks will be used up, opening the way for sustainable grown biomass.

In 1992, the use of wood energy and other biomass energy resources to produce electricity resulted in a net impact of more than $1.8 billion in personal and corporate income throughout the United States. More than 66,000 jobs are presently being supported by this income. By the year 2010, the economic benefits are anticipated to triple as advanced biomass power technologies and energy crops are commercialized.

According to a 1992 DOE study, "Electricity from Biomass", sustainable biomass crops could easily provide over 10 quads, or over 10%, of U.S. energy demand. Moreover, a sustainable biomass program reduces the impact of carbon emissions from other industries; a full-blown program has the potential to sequester nearly 50% of our carbon emissions. An energy technology that reduces rather than increases carbon emissions, produces domestic jobs, and provides clean, reliable energy!

Biomass power production has come to a crossroads in the 1990s and is poised for significant growth. It can directly create a substantial jump in the employment market directly, and because biomass production is evenly dispersed geographically it keeps energy dollars spent within the community, boosting the economy. Contrast this recycling of income within local communities to the export of money to foreign oil-producing countries that our dependence on conventional fuels has all but institutionalized. Expanding this credit would revitalize communities by providing them with a way to help themselves.

In the many regions of the country where the cost of biomass power is competitive with fossil fuels, biomass power is clearly the preferable option. Biomass is safer for the environment than conventional fossil fuels because it does not increase carbon dioxide emissions into the atmosphere, causing changes in our global climate. At the same time, utilizing biomass power decreases waste dumping in our nation's landfills. With so many unique advantages and opportunities for biomass power, the United States must push this technology to the forefront in the overall energy picture.

REQUEST

Biomass contributes more electric and thermal energy than any other renewable except hydropower. Yet the federal government's policies and programs do not reflect the importance of biomass's contribution to our energy mix. The Energy Policy Act of 1992 excludes biomass energy derived from wood waste, forest and agricultural residues from qualifying for the 1.5 cent biomass production credit. As over 98% of all biomass electricity is generated from waste, particularly wood waste, these exclusions make the production credit all but useless for the U.S. biomass industry.

The following correction to the Energy Policy Act Section 45 will allow the tax credit to be used as it was intended, by including biomass that is harvested on a sustainable basis, not purely "grown":

Closed loop biomass includes all growing matter harvested on a sustainable basis in compliance with state and local government regulations incorporating timber harvested via sustainable forest-management practices, forest residues, wastewood and agricultural residues. Biomass-electric facilities using mixed wastes, municipal solid wastes, tires or

the harvesting of old growth forests (wood stands of more than 35 years are used) in no case will be eligible for the production credit.

Agricultural residues and wood wastes are often seen as garbage and thrown away. Wood wastes account for nearly one-third of U.S. landfills, and unless combusted properly, the feedstocks degrade, contributing to overall carbon and methane emissions as well as to groundwater contamination. These so-called wastes represent a valuable source of energy, as can be seen by the fact that the vast majority of the 3500 megawatts of electricity produced by the U.S. direct-combustion biomass industry is fueled by wastewood and agricultural residues. These wastes, if allowed to degrade, continue to create immense environmental problems.

Although some facilities take advantage of the stored energy found in these by-products, their exclusion from the tax credit obstructs the growth of this industry. This obstruction represents a most unfortunate short-sightedness. At a time when we are trying to reduce U.S. demand for expensive, potentially insecure foreign energy and when the need for new job-creating industries is high, we cannot afford to ignore the opportunity biomass represents.

The biomass industry creates jobs directly as well as indirectly giving a boost to a number of related industries through a ripple effect. Three studies performed within DOE's Regional Biomass Energy Program all supported this view, and if the results of these analyses are extrapolated to the U.S. as a whole, it is estimated that using biomass energy would produce several billion dollars in income annually and help to sustain hundreds of thousands of jobs. These benefits, when looking at the economic impact of both residential and industrial wood combustion, totalled 142,696 new jobs and $2,703 million in new income in the Southeast; 113,583 jobs and $2,142 million in the Great Lakes region; 46,093 jobs and $875 million in the West; 22,060 jobs and $421 million in the Northwest; and 89,854 jobs and $2,131 million in the Northeast. This totals up to be 414,286 new jobs and $8,272 million in new income across the country.

A study completed by Meridian Corporation and Antares Group for DOE's Biomass Power Program echoes the positive impact biomass power can have for the U.S. economy. If technology continues to be commercialized, by the year 2010 283,838 Americans will be employed by the biomass industry and the annual net income for the industry will be $6,163 million. Biomass is a meeting grounds for the interrelated goals of job creation, industrial efficiency, assurance of a reliable and secure source of energy, and environmental protection.

Expanding the biomass production tax credit would allow the credit to do what it was meant to do in the first place, which is to jump-start an industry with many environmental and economic benefits. Looking at the big picture, it becomes obvious that expanding the credit to include biomass energy from wastewood and forest and agricultural residues would pay back handsomely. It would significantly decrease pressure on our rapidly filling landfills, prevent pollution, and provide secure jobs. Equally importantly, it would pave the way for the development of a biomass industry based on sustainable crops-- which will not happen until the reserves of wastes are depleted.

CONCLUSION

A sustainable biomass program would multiply the benefits of the current biomass industry. Since new industries such as forestry and logging would be involved, job creation would spiral upwards. Depending on the assumptions and programs, the U.S. biomass industry can create 100,000 to 350,000 jobs within the next 20 years alone. The potential to create wealth in areas of the country previously locked out of the possibility of real economic growth is astonishing.

The United States has been the industrial and technological leader of the world for decades. In the current increasingly competitive world market, it is essential that we not pass over promising emerging industries simply because they are new and different. A growing biomass industry will be a shot in the arm for the economy, not to mention its many environmental benefits that will protect Americans' health and ensure that our children have the resources necessary to maintain this country's position of leadership.

Mr. KOPETSKI. Now we will hear from Michael Marvin, director of governmental and public affairs for the American Wind Energy Association.

STATEMENT OF MICHAEL L. MARVIN, DIRECTOR OF GOVERNMENTAL AND PUBLIC AFFAIRS, AMERICAN WIND ENERGY ASSOCIATION

Mr. MARVIN. Thank you, Mr. Chairman.

I appreciate the chance to discuss some of the key issues surrounding implementation of the section 45 energy production credits which the Ways and Means Committee included as part of title 19 to last year's Energy Policy Act.

Included as an attachment to my written testimony is a financial spread sheet that shows the crux of our problem. As a result of the more intensive up-front capital costs of wind projects and other renewable energy projects, independent project developers are realizing the production credit is of limited value because of the AMT situation in which they find themselves. Because of the high financing costs and the depreciation schedule, a project developer must wait until at least the 11th year of a project's life to use the first year of the production credits enacted last year, thus reducing the value of the credit by a minimum of one-third.

Since the stated objective of the credit when it was passed was to serve as a contemporaneous price floor, the inability to use the credit until 10 years after it is earned fails to provide the intended price support. The problem can be addressed if the section 45 energy production credit can offset the alternative minimum tax.

Full scale AMT relief has been suggested by Representative Bill Thomas of the committee. Representative McDermott, in H.R. 2026, has suggested 25 percent relief from AMT for users of section 45 or 48 credits.

AMT relief would accomplish several objectives. First, it would help to fulfill this committee's stated objectives of increased electricity generation by wind energy.

Second, it would comport with President Clinton's support for using the Tax Code to encourage investment in renewable energy.

Third, it would assist in meeting the commitment made by President Clinton to return to 1990 levels of greenhouse gas emissions by the year 2000.

Fourth, it would place wind developers on a more even footing with its oil and gas competitors.

And, finally, it would generate jobs. Studies show that wind energy creates more jobs per unit of energy than any other technology available today.

Chairman Rangel earlier this morning asked that we provide comments on Treasury's position. On Tuesday, Treasury stated that it did oppose full AMT relief for section 45 and 48 credit users on the grounds that it would accord those credits more favorable treatment than other tax credits and thereby weaken the purpose of the AMT.

In response, let me note that the foreign tax credit is allowed to offset AMT, and many investment tax credits under the 1986 Tax Reform Act were allowed to offset 25 percent of the AMT. Further, the investment tax credit which President Clinton himself proposed

that ultimately was not included as part of the reconciliation provision also would have been allowed to offset the AMT.

In line with these precedents, we are proposing that section 45 production credit for wind be allowed to offset a limited amount of the AMT.

With regard to Treasury's second concern, even with a partial offset a taxpayer still would be required to pay significant alternative minimum tax on his economic income. This partial offset requested is even more modest than the complete exemption Congress provided to independent oil and gas producers for depletion allowances and intangible drilling expense deductions as tax preference items, also included as part of title 19 of the Energy Policy Act.

Congress recognized similar issues facing the Nation's oil and gas producers. Capital intensiveness, combined with the somewhat risky nature of exploration, justified the AMT granted to independents last year. Wind energy development, with its capital intensiveness and generally risky nature as a "new technology," is finding obstacles similar to and in many cases even larger than the oil and gas independents.

I also want to briefly mention another key provision in title 1 of Representative McDermott's legislation. Currently, all wind systems, regardless of size, are included in the production credit of section 45. Most small turbines are sold for ranching and farming activities in the United States, displacing diesel generators, and, in some cases, displacing electricity.

We would request that these turbines be included as part of section 48 business tax credits and specifically excluded from the production tax credit to ensure no double-dipping. We would estimate a maximum revenue loss of about $2 million over 5 years, significantly different than what the joint committee has offered, but we are working with them to work on similar assumptions.

U.S. wind companies are small entrepreneurial companies that face a wealth of obstacles in a real market, in an electricity market that is dominated by natural gas and by coal. And tax policy does help to determine energy policy, Mr. Chairman.

While we understand the difficult fiscal situation in which we as a country and which this committee specifically finds itself, we ask only that new, nonfuel—using technologies such as wind be treated equitably with its larger fossil fuel energy brethren.

Thank you for your time.

Mr. KOPETSKI. Thank you, Mr. Marvin.

[The prepared statement and attachments follow:]

777 N. Capitol Street N.E., Suite 805, Washington, D.C. 20002 U.S.A. 202/408-8988
Telex: 6503304640 MCI UW Fax: 202/408-8536

Statement of Michael L. Marvin
Director of Governmental and Public Affairs
The American Wind Energy Association
Submitted to the Subcommittee on Select Revenue Measures
Committee on Ways and Means
United States House of Representatives
June 24, 1993

The attached comments are submitted on behalf of the American Wind Energy Association, a trade association of wind energy equipment manufacturers, service providers, project developers, academicians, utilities and individuals interested in wind energy development. The Association is located at 777 North Capitol Street, N.E., Suite 805, Washington, D.C. 20002, telephone 202-408-8988.

The attached comments make the following points:

1. As part of the Energy Policy Act of 1992, Congress enacted the section 45 production credit to encourage wind and closed-loop biomass development by providing a price floor for electricity generated from these energy resources.

2. The congressional objective is not being achieved because:

   a. The alternative minimum tax prevents the production credit from being used until the eleventh through the twenty-fourth year of a wind project.

      1. This results in a one-third decrease in value of the credits earned in the initial 10 years of the project.

      2. This also prevents the credit from serving as a contemporaneous price support for the project.

   b. The confusion over the section 45 eligibility of a project under an operations contract is also deterring investors.

   c. While the section 45 production credit has created investment interest in utility wind projects which use large turbines, it has not stimulated similar interest in small turbines for use in ranch and farm operations.

For these reasons, the American Wind Energy Association urges: (1) adoption of alternative minimum tax relief which would allow the use of the section 45 production credit against the alternative minimum tax, (2) clarification of section 45 as to the qualification of projects under an operations contract, and (3) extension of the present section 48 energy investment credit to include investments in small wind turbines.

I. BACKGROUND.

Congress in the Energy Policy Act of 1992, Public Law 102-486, intended to increase the use of renewable energy resources in the electric sector as well as promote additional competition in wholesale electricity power markets. As Congress noted at the time, renewable energy developers are typically small firms, and development is hampered by the high, up-front project costs as well as by high interest rates required by lenders who are unfamiliar with the technology. House Report 102-474, Part 1, pages 138, 145-146 (March 30, 1992), and Senate Report 102-72, pages 209-210 (June 5, 1992).

The tax code at that time already provided incentives for conventional oil and gas production as well as for oil produced from shale and tar sands and gas produced from geopressured brine, Devonian shale, coal seams, and tight formation. It also provided incentives for solar and geothermal energy investments. To continue and expand these pre-existing provisions, the Ways and Means Committee made permanent the tax credit for solar and geothermal investments and enacted alternative minimum tax relief for the oil and gas industry.

Congress additionally sought to open commercial markets for other, non-solar/geothermal renewable energy project development. In this regard, the Ways and Means Committee included in the Energy Policy Act of 1992 a production credit for electricity produced from wind and closed-loop biomass resources. The committee thus added section 45 of the tax code. The committee explained the purpose of this new credit in this manner:

> The committee believes that the development and utilization of certain renewable energy sources should be encouraged through the tax laws. A production-type credit is believed to target exactly the activity that the committee seeks to subsidize (the production of electricity using specified renewable energy sources). The credit is intended to enhance the development of technology to utilize the specified renewable energy sources and to promote competition between renewable energy sources and conventional energy sources. The committee believes that if the national average price of electricity is sufficiently high, the need for a tax subsidy is reduced. Accordingly, the tax credit will be phased out in the event that the price of electricity generated from these sources is sufficiently high. The credit is scheduled to sunset after June 30, 1999, to provide the committee with the opportunity to assess the effectiveness of the credit in encouraging the utilization of renewable energy sources.

House Report 102-474, Part 6, page 42, 102d Congress, 2d Session. The Senate Finance Committee adopted the House amendment with the same objective. Congressional Record, Daily Edition, June 18, 1992, page S 8486.

II. PROBLEMS WITH THE PRODUCTION CREDIT.

Due to revenue constraints, Congress postponed the effective date of the section 45 credit for wind electric generation projects until the end of 1993. Developers, however, have begun to negotiate the construction of facilities in anticipation of the effective date. In these discussions, two problems -- involving the alternative minimum tax and the uncertainty of a project's qualification under an operations contract -- have arisen which impair the utilization of the production credit. In addition, while the production credit has stimulated investment interest in large-size wind turbines, it has not fostered comparable interest in small-size wind turbines. These problems are explained below.

A. Alternative Minimum Tax.

In the Tax Reform Act of 1986, Congress enacted the present alternative minimum tax to insure that any taxpayer with substantial economic income could not avoid significant tax liability. Congress believed that the exclusions, deductions, and credits in the tax code provided incentives to reach worthy goals, but they became counterproductive when taxpayers used them to avoid nearly all tax liability. It was politically intolerable that high-income individuals and highly profitable corporations not pay taxes. Thus, if a taxpayer's economic income exceeded regular taxable income, an alternative 20 percent tax for corporations and 24 percent for individuals was levied on economic income as a minimum tax liability.

The unforeseen effect of the alternative minimum tax on section 45 credit users, however, has been to prevent contemporaneous use of the production credit and to diminish by one-third the value of the credit when finally utilized. Wind projects, in the initial 10 years of operations, do not generate sufficient taxable income to utilize the section 45 production credit. The projects' gross income chiefly covers operational costs and amortization of the loan; the remaining income is virtually offset by depreciation deductions. The production credit could be utilized to offset other corporate earnings, but the production credit cannot be used to reduce the net alternative minimum tax.

As this subcommittee is well aware, the majority of corporate taxpayers are subject to the alternative minimum tax and this situation has created a disincentive for investment in certain property. That disincentive is certainly evident in the wind electric generation industry, because of: (1) the high up-front capital cost required for wind projects; (2) the inability to use the production credit against the alternative minimum tax; and (3) the lack of contemporaneous price support from the credit due to the alternative minimum tax deferral of the credit.

The attached spreadsheet analysis (Case 1) of a stand-alone wind project shows that the alternative minimum tax restrictions prevent the production credit from being used until the project's eleventh year. The production credits are not fully utilized until the twenty-fourth year of the project. Assuming a four percent annual inflation factor, we conclude that the value of the production credit is at least one-third less than the Ways and Means Committee had projected when it adopted the credit last year. Specifically, $1 of the production credit which is earned in 1994 cannot be used until the year 2004. At that time, the $1 credit will be worth 66 cents, because of the decrease in the credit's value over the 10 year period -- between the time the credit is earned in the project's first year and the time the credit is used in the eleventh year of the project. Moreover, the production credit is not providing a contemporaneous price support for commercialization which the Ways and Means Committee intended when it adopted section 45.

The need to modify the alternative minimum tax so as to remove the investment disincentive is generally acknowledged. The Clinton Administration has proposed, and the Ways and Means Committee has included in its budget reconciliation recommendations, a modification of the alternative minimum tax recovery period. Under this modification, the depreciation recovery period for purposes of the regular tax would also control for purposes of the alternative minimum tax. But, as the attached spreadsheet (Case 2) shows, this modification does not address the problem caused by deferral of the production credit. Even with the proposed depreciation modification, the taxpayer in a stand-alone wind project still cannot utilize the credit until the eleventh year. The purpose of the credit is again frustrated by the diminished value of the credit and the lack of contemporaneous price support.

The solar and geothermal industries share this problem under the section 48 solar and geothermal investment credit. These industries have proposed that the section 48 geothermal and solar credit be allowed to offset 100 percent of the alternative minimum tax. If this subcommittee and the full Ways and Means Committee are inclined to favor this approach, the American Wind Energy Association requests that this relief also be extended to taxpayers under the section 45 production credit as well.

As an alternative, the association requests the subcommittee to consider the approach taken by Representative Jim McDermott in section 101 of his bill H.R. 2026, and as requested by Congressman Bill Thomas. This approach would maintain the underlying objective of the alternative minimum tax, while still implementing the incentives for renewable energy development. Aside from the credit for foreign taxes, other credits cannot reduce the alternative minimum tax. But Congress in the 1986 Tax Reform Act created an exception for the investment credit. The investment credit could offset up to 25 percent of the alternative minimum tax for corporate taxpayers. The repeal of the investment credit in 1986 and its limited extension for transition property effectively ends this offset. Nonetheless, this does establish a precedent which the Clinton Administration followed in its own investment tax credit proposal.

In line with this precedent, the American Wind Energy Association proposes that corporate taxpayers be allowed to claim a similar offset for the section 45 production credit to provide a measure of relief. By limiting the maximum relief to 25 percent, the basic congressional concern to insure that taxpayers with economic income not avoid taxes is still met. This

proposal to permit a reduction of the alternative minimum tax up to 25 percent is less favorable than the foreign tax credit approach; and the proposed offset for energy tax credits, together with the existing foreign tax credit, cannot reduce the minimum tax liability by more than 90 percent. But the partial reduction of the minimum tax would allow the wind and closed-loop biomass production credit to encourage renewable energy development. Such a measure would allow taxpayers in a stand-alone project to utilize the production credit sooner; it would also allow corporations to use the credit sooner against other sources of income.

B. Clarification of Eligibility Under an Operations Contract.

Under section 45, a taxpayer who owns a qualified wind generation facility and who produces and sells the power generated at the facility may claim the production credit. The conference explanation requires the taxpayer to both own and operate the facility. The conference report on the Energy Policy Act of 1992 explains:

> [I]n order to claim the credit, a taxpayer must own the facility and sell the electricity produced by that facility to an unrelated party. Accordingly, a public utility which owns and operates a qualified facility would be able to claim the credit to the extent that the utility ultimately sells the electricity generated to unrelated parties.

Independent power production projects are usually owned by a partnership of corporate investors which will employ experienced companies to manage the project and maintain the equipment. A windfarm developer typically will enter into a power sales contract with a utility, build the windfarm, and sell it to a partnership comprised of other corporations. The developer will also assign a portion of the power sales contract to the partnership to cover the electricity produced at the windfarm. To manage its windfarm, the partnership will contract with an entity often related to the developer.

The management contract requires the manager, among other duties, to operate the windfarm on behalf of the partnership; collect, account for, and remit payments to the partnership; and monitor and record power production and sales. The manager typically receives a percentage of gross revenues (about one percent) as compensation. The partnership remains liable for personal property taxes, insurance premiums, and any personal injury or property damage at the windfarm. The partnership will indemnify the manager except for liability caused by the manager's own recklessness or willful conduct.

In addition to contracting for management services, the partnership will contract for maintenance services. The maintenance contract requires repair, preventive maintenance, and periodic overhaul of the windfarm. The maintenance contractor is compensated with a percentage of the gross revenues (generally around five percent) and is responsible for providing labor, parts, and equipment. The partnership, however, is responsible for the cost of replacing any turbine or equipment which is damaged beyond repair or which is destroyed.

Windfarms have been in operation for a sufficiently long period so that companies unrelated to any developer have been created to provide management as well as maintenance services. Thus, the windfarm owners now have the option to contract with unrelated third parties to manage and maintain the facilities.

The Federal Energy Regulatory Commission, for purposes of the Public Utility Holding Company Act (PUHCA), has held that such operations and maintenance contracts constitute an agency relationship. An operator under an operations contract is the agent of the facility owner. Pursuant to the PUHCA amendments enacted in the Energy Policy Act of 1992, the commission modified its regulations to exempt an operator of an eligible facility under PUHCA. The commission explained the practice of operations and maintenance contractors in this manner:

> While the operator will be responsible for day-to-day operations, these agreements typically provide that the owner/seller will direct or control the services provided by the operator. In other words, the operator in effect is an agent of the owner/seller because the owner/seller, at a minimum, directs the activities of the operator.

Under PUHCA, if the operator were not engaged in the business of owning and/or operating eligible facilities and selling electric energy at wholesale, the operator could not qualify for exempt wholesale generator status; in this event, the operator would be subject to heavy regulation as a utility. To interpret PUHCA in this way, the commission stated, would frustrate the 1992 congressional amendments which intended to promote competition in electric generation through partial deregulation of exempt wholesale generators. To implement the congressional intent, the commission therefore amended its regulation to extend the exempt wholesale generator status to the operator of a facility under an O&M agreement. See the Federal Energy Regulatory Commission Order No. 550-A, 58 Federal Register 21250, at 21254 (April 20, 1993).

The Federal Energy Regulatory Commission acknowledged that this issue has "significant and recurring impact on the development" of exempt wholesale generators. The commission therefore resolved the issue with respect to PUHCA. But this issue has not yet been resolved for the Internal Revenue Code. In view of the importance of this issue to the industry and the importance to the development of renewable energy commercialization, the American Wind Energy Association urges this subcommittee to clarify that a taxpayer who owns a wind project and operates it through an agent under an operations contract, still meets the operations requirement for the production credit.

C. Extending 10 Percent Solar and Geothermal Credit to Small Wind Turbines.

The existing section 48 credit provides a 10 percent business investment credit only for solar and geothermal equipment. In contrast, the existing section 45 production credit applies to close-loop biomass equipment and wind turbines which generate power for sale. Consequently, when wind-generated electricity is not sold to an outside party, no tax incentive is provided for wind equipment which is used in the taxpayer's own business. Thus no encouragement is offered for farmers and ranchers who use wind turbines to generate power for agricultural operations and not for sale to others. Generally, small wind turbines are used in such applications.

It is proposed that the existing 10 percent solar and geothermal energy credit be extended to small wind turbines (of 50 kilowatt or less rated generation capacity) used in a taxpayer's trade or business, provided the equipment is not primarily used to generate electricity for sale to another party. To prevent a taxpayer from getting both an energy credit and the production credit, the American Wind Energy Association proposes that section 48 prohibit double dipping of energy tax credits. Our best analysis shows that, given the size of the current small wind turbine industry, and assuming a 25 percent annual growth (which has not been experienced since the early 1980s), the revenue loss to the Treasury will be $1.35 million* over five years, as follows:

Year 1	$165,000
Year 2	206,200
Year 3	257,800
Year 4	322,300
Year 5	402,800
TOTAL	**$1,354,100**

(*--assumptions: annual market of $4.95 million, which is higher than our best estimates; one-third of turbines eligible for credit (other turbines sold internationally and to residential/consumers)

The association urges enactment of this proposal, contained in section 102 of H.R. 2026.

Comparison of Regular Tax and Alternate Minimum Tax Impact
On a Windfarm Project

Assumptions

1. 30 megawatt windfarm
2. $33,00,000.00 total project cost
   a. $29,750,000 in wind equipment depreciated as 5-year property
   b. $3,300,000 in land improvements depreciated as 10-year property
3. $24,750,000 (75% of cost) debt financed
   15 years at 8% with levelized payments
4. $8,250,000 equity
5. January 1, 1994 place-in-service date
6. $800,000 annual operating costs ($1994)
7. 80,000,000 annual kilowatt hours production and sale
8. 6 cents per kilowatt hour sale price ($1994)
9. 4% general inflation for adjustment of
   a. operating costs
   b. kilowatt hour sale price
   c. 1.5 cent production credit
      (adjusted to nearest .1 cent)

CASE 1 - CURRENT LAW: COMPARISON OF REGULAR TAX AND ALTERNATIVE MINIMUM TAX IMPACT ON A WINDFARM PROJECT — Values expressed in $1,000s

Year	01 1996	02 1997	03 1998	04 1999	05 2000	06 2001	07 2002	08 2003	09 2004	10 2005	11 2006	12 2007	13 2008	14 2009	15 2010	16 2011	17 2012	18 2013	19 2014	20 2015	21 2016	22 2017	23 2018	TOTAL Year
I. REGULAR TAX																								REGULAR TAX
Gross Income	4,000	4,992	9,192	9,390	9,619	9,840	6,674	6,316	6,569	6,832	7,105	7,389	7,685	7,992	8,312	8,645	8,990	9,350	9,724	10,113	10,517	10,938	11,376	11,831	12,304	199,908 Gross Income
Operating Costs	800	832	869	908	956	973	1,012	1,053	1,095	1,139	1,184	1,232	1,281	1,332	1,385	1,441	1,498	1,558	1,621	1,685	1,753	1,823	1,896	1,972	2,051	33,317 Operating Costs
Debt Interest Payment	1,948	1,874	1,794	1,707	1,613	1,513	1,405	1,292	1,173	1,013	862	698	520	328	119	0	0	0	0	0	0	0	0	0	0	17,825 Debt Interest Payment
Net Income	2,052	2,286	6,532	6,776	7,050	7,355	3,669	3,969	4,321	4,680	5,059	5,460	5,884	6,332	6,808	7,204	7,492	7,792	8,103	8,427	8,764	9,115	9,480	9,859	10,253	148,759 Net Income
Depreciation	4,102	4,210	4,094	3,674	3,650	1,917	195	195	195	195	195	195	195	195	195	97	0	0	0	0	0	0	0	0	0	33,059 Depreciation
Adjusted Net Income or (Loss)	(6,823)	(7,552)	(2,452)	(882)	(584)	1,430	3,466	3,757	4,126	4,469	4,844	5,263	5,689	6,137	6,613	7,107	7,492	7,792	8,103	8,427	8,764	9,115	9,480	9,859	10,253	115,699 Adjusted Net Income or (Loss)
Net Operating Loss Carryforward	(6,823)	(14,385)	(16,837)	(17,718)	(18,302)	(16,883)	(13,416)	(9,660)	(5,534)	(1,065)	3,779	9,042	14,731	20,868	27,481	34,588	42,080	49,872	57,975	66,402	75,166	84,281	93,761	103,620	113,873	
Taxable Income	0	0	0	0	0	0	0	0	0	0	790	4,864	9,265	9,469	6,137	6,613	7,107	7,492	7,792	8,103	8,427	8,764	9,115	9,480	9,859	10,253	119,799 Taxable Income
Tax (34% Corporate Rate)	0	0	0	0	0	0	0	0	0	0	271	1,654	1,790	1,934	2,087	2,248	2,416	2,547	2,649	2,759	2,865	2,980	3,099	3,223	3,352	3,486	39,358 Tax (34% Corporate Rate)
Production Credit Used	0	0	0	0	0	0	0	0	0	0	210	1,247	1,349	1,437	1,371	1,402	1,910	1,917	1,992	1,326	0	0	0	0	0	0	14,480 Production Credit Used
Current Year's Production Credit	1,200	1,200	1,200	1,368	1,448	1,448	1,328	1,600	1,600	1,600	1,600	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	14,480 Total Production Credit Earned
Accumulated Prod. Cr. Carryf'd	1,200	2,400	3,760	5,128	6,568	8,008	9,328	11,128	12,888	14,488	13,378	12,204	11,107	10,346	9,423	8,617	7,336	6,213	5,062	3,882	2,683	1,379	92	0	0	0	Accumulated Prod. Cr. Carryf'd
II. ALTERNATIVE MINIMUM TAX																								ALTERNATIVE MINIMUM TAX
Gross Income	4,000	4,992	9,192	9,390	9,619	9,840	6,674	6,316	6,569	6,832	7,105	7,389	7,685	7,992	8,312	8,645	8,990	9,350	9,724	10,113	10,517	10,938	11,376	11,831	12,304	199,908 Gross Income
Operating Costs	800	832	869	908	956	973	1,012	1,053	1,095	1,139	1,184	1,232	1,281	1,332	1,385	1,441	1,498	1,558	1,621	1,685	1,753	1,823	1,896	1,972	2,051	33,317 Operating Costs
Debt Interest Payment	1,948	1,874	1,794	1,707	1,613	1,512	1,405	1,292	1,173	1,013	862	698	520	328	119	0	0	0	0	0	0	0	0	0	0	17,825 Debt Interest Payment
Net Income	2,252	2,286	6,532	6,776	7,050	7,355	3,669	3,969	4,321	4,680	5,059	5,460	5,884	6,332	6,808	7,204	7,492	7,792	8,103	8,427	8,764	9,115	9,480	9,859	10,253	148,759 Net Income
Depreciation	1,904	2,769	3,286	2,685	2,934	2,543	2,548	2,548	2,548	2,548	2,548	2,548	1,258	163	163	163	163	62	0	0	0	0	0	0	0	0	33,062 Depreciation
Adjusted Net Income or (Loss)	56	(1,499)	(756)	(93)	328	998	1,311	1,642	1,981	2,348	2,719	3,128	4,834	6,169	6,663	7,061	7,329	7,629	8,021	8,427	8,764	9,115	9,480	9,859	10,253	115,757 Adjusted Net Income or (Loss)
AMT Net Operating Loss Carryf'd	0	(1,459)	(2,213)	(2,328)	(1,771)	(781)	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	(8,531)	AMT Net Operating Loss Carryf'd
AMT Tentative Taxable Income	56	0	0	0	0	0	328	1,642	1,981	2,348	2,719	3,128	4,834	6,169	6,663	7,061	7,329	7,629	8,021	8,427	8,764	9,115	9,480	9,859	10,253	119,757 AMT Tentative Taxable Income
AMT Tax (20% Corporate Rate)	12	0	0	0	0	0	106	328	396	468	544	626	967	1,234	1,329	1,408	1,466	1,526	1,604	1,685	1,753	1,823	1,896	1,972	2,051	23,151 AMT Tax (20% Corporate Rate)
AMT Credit	12	0	0	0	0	0	106	328	396	468	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	1,310	AMT Credit
Accumulated AMT Credit Carryf'd	12	12	12	12	12	12	118	446	842	1,310	1,310	1,310	1,310	1,310	1,310	1,310	1,310	1,310	1,310	1,310	1,310	1,310	1,310	1,310	1,310	0	Accumulated AMT Credit Carryf'd
III. INTERACTION OF AMT WITH REGULAR TAX																										INTERACTION OF AMT WITH REGULAR TAX
Regular Tax	0	0	0	0	0	0	0	0	0	271	1,654	1,790	1,934	2,087	2,248	2,416	2,547	2,649	2,759	2,865	2,980	3,099	3,223	3,352	3,486	39,358 Regular Tax
Tentative Alternative Minimum Tax	12	0	0	0	0	0	106	328	396	468	544	626	967	1,234	1,329	1,408	1,466	1,526	1,604	1,685	1,753	1,823	1,896	1,972	2,051	23,151 Tentative Alternative Minimum Tax
Tax (Higher of Regular or Amt)	12	0	0	0	0	0	106	328	396	468	1,654	1,790	1,934	2,087	2,248	2,416	2,547	2,649	2,759	2,865	2,980	3,099	3,223	3,352	3,486	40,397 Tax (Higher of Regular or AMT)
AMT Credit Used	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	1,310	AMT Credit Used
Production Credit Used	0	0	0	0	0	0	0	0	0	1,110	1,166	1,037	853	919	1,008	1,081	1,123	1,151	1,108	1,227	1,276	1,327	92	0	0	14,480	Production Credit Used
Tax Payment	12	0	0	0	0	0	106	328	396	468	544	626	967	1,234	1,329	1,408	1,466	1,526	1,604	1,685	1,753	1,823	1,896	1,972	2,051	24,607 Tax Payment
Expired, Unused Production Credit	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0 Expired, Unused Production Credit

CASE 2 - CLINTON ADMINISTRATION PROPOSAL, COMPRISED OF REGULAR TAX AND ALTERNATIVE MINIMUM TAX IMPACT ON A WINDFARM PROJECT (Values expressed in $1,000s)

Year	01 1994	02 1995	03 1996	04 1997	05 1998	06 1999	07 2000	08 2001	09 2002	10 2003	11 2004	12 2005	13 2006	14 2007	15 2008	16 2009	17 2010	18 2011	19 2012	20 2013	21 2014	22 2015	23 2016	24 2017	25 2018	TOTAL Year
I. REGULAR TAX																										REGULAR TAX
Gross Income	4,889	4,992	5,192	5,399	5,615	5,840	6,074	6,316	6,569	6,832	7,105	7,389	7,685	7,992	8,312	8,643	8,990	9,350	9,724	10,113	10,517	10,938	11,376	11,831	12,304	199,908 Gross Income
Operating Costs	888	852	868	900	936	973	1,012	1,052	1,093	1,136	1,181	1,228	1,277	1,328	1,381	1,436	1,494	1,554	1,616	1,681	1,748	1,818	1,891	1,972	2,051	33,217 Operating Costs
Debt Interest Payment	1,940	1,874	1,796	1,707	1,613	1,512	1,402	1,282	1,153	1,013	862	690	528	326	179	0	0	0	0	0	0	0	0	0	0	17,825 Debt Interest Payment
Net Income	2,052	2,286	2,532	2,792	3,066	3,353	3,659	3,982	4,321	4,683	5,062	5,471	5,880	6,338	6,888	7,206	7,496	7,796	8,108	8,427	8,784	9,119	9,485	9,859	10,253	148,759 Net Income
Depreciation	6,133	9,818	5,984	3,674	3,656	1,917	199	199	199	199	199	199	199	199	199	97	0	0	0	0	0	0	0	0	0	33,000 Depreciation
Adjusted Net Income or (Loss)	(4,082)	(7,532)	(3,453)	(882)	(591)	1,436	3,460	3,782	4,122	4,485	4,864	5,272	5,680	6,137	6,613	7,107	7,496	7,796	8,108	8,427	8,784	9,119	9,485	9,859	10,253	115,759 Adjusted Net Income or (Loss)
Net Operating Loss Carryforward	(4,082)	(11,582)	(15,037)	(15,918)	(16,508)	(15,084)	(11,624)	(7,842)	(3,667)	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Taxable Income	0	0	0	0	0	0	0	0	0	796	4,864	5,272	5,680	6,137	6,613	7,107	7,496	7,796	8,108	8,427	8,784	9,119	9,485	9,859	10,253	115,759 Taxable Income
Tax (34% Corporate Rate)	0	0	0	0	0	0	0	0	0	271	1,654	1,792	1,931	2,087	2,248	2,416	2,547	2,650	2,757	2,865	2,986	3,099	3,223	3,352	3,486	39,358 Tax (34% Corporate Rate)
Production Credit Used	0	0	0	0	0	0	0	0	0	210	1,347	1,360	1,457	1,571	1,692	1,916	1,917	1,993	1,236	0	0	0	0	0	0	14,480 Production Credit Used
Current Year's Production Credit	1,200	1,200	1,200	1,200	1,668	1,440	1,520	1,680	1,680	1,680	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	14,480 Total Production Credit Earned
Accumulated Prod. Cr. Carryf'd	1,200	2,400	3,780	5,118	6,598	8,028	9,520	11,128	12,808	14,488	13,321	12,108	11,073	10,217	9,294	8,385	7,198	6,072	4,928	3,748	2,513	1,257	0	0	0	0 Accumulated Prod. Cr. Carryf'd
II. ALTERNATIVE MINIMUM TAX																										ALTERNATIVE MINIMUM TAX
Gross Income	4,889	4,992	5,192	5,399	5,615	5,840	6,074	6,316	6,569	6,832	7,105	7,389	7,685	7,992	8,312	8,643	8,990	9,350	9,724	10,113	10,517	10,938	11,376	11,831	12,304	199,908 Gross Income
Operating Costs	888	852	868	900	936	973	1,012	1,052	1,093	1,136	1,181	1,228	1,277	1,328	1,381	1,436	1,494	1,554	1,616	1,681	1,748	1,818	1,891	1,972	2,051	33,217 Operating Costs
Debt Interest Payment	1,940	1,874	1,796	1,707	1,613	1,512	1,402	1,282	1,153	1,013	862	690	528	326	179	0	0	0	0	0	0	0	0	0	0	17,825 Debt Interest Payment
Net Income	2,052	2,286	2,532	2,792	3,066	3,353	3,659	3,982	4,321	4,683	5,059	5,471	5,880	6,338	6,888	7,206	7,496	7,796	8,108	8,427	8,784	9,119	9,485	9,859	10,253	148,759 Net Income
Depreciation	1,394	3,026	2,739	2,592	2,585	2,585	2,585	2,585	2,585	2,585	2,585	2,386	1,391	178	179	178	179	178	69	0	0	0	0	0	0	33,000 Depreciation
Adjusted Net Income or (Loss)	658	(740)	(206)	200	481	768	1,074	1,397	1,736	2,099	2,475	2,876	4,505	6,156	6,689	7,026	7,313	7,614	8,014	8,427	8,784	9,119	9,485	9,859	10,253	115,759 Adjusted Net Income or (Loss)
AMT Net Operating Loss Carryf'd	0	(758)	(956)	(274)	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	(2,754) AMT Net Operating Loss Carryf'd
AMT Tentative Taxable Income	658	0	0	0	288	496	1,074	1,397	1,736	2,099	2,475	2,876	4,505	6,156	6,689	7,026	7,313	7,614	8,014	8,427	8,784	9,119	9,485	9,859	10,253	113,966 AMT Tentative Taxable Income
AMT Tax (20% Corporate Rate)	92	0	0	0	43	99	215	279	347	419	495	575	901	1,231	1,338	1,405	1,463	1,523	1,603	1,685	1,757	1,823	1,896	1,972	2,051	23,193 AMT Tax (20% Corporate Rate)
AMT Credit	92	0	0	0	43	99	215	279	347	419	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	1,493 AMT Credit
Accumulated AMT Credit Carryf'd	92	92	92	92	135	232	447	727	1,074	1,493	1,493	1,493	1,493	1,493	1,493	1,493	1,493	1,493	1,493	1,493	1,493	1,493	1,493	(0)	(0)	0 Accumulated AMT Credit Carryf'd
III. INTERACTION OF AMT WITH REGULAR TAX																										INTERACTION OF AMT WITH REGULAR TAX
Regular Tax	0	0	0	0	0	0	0	0	0	271	1,654	1,792	1,931	2,087	2,248	2,416	2,547	2,650	2,757	2,865	2,986	3,099	3,223	3,352	3,486	39,358 Regular Tax
Tentative Alternative Minimum Tax	92	0	0	0	43	99	215	279	347	419	495	575	901	1,231	1,338	1,405	1,463	1,523	1,603	1,685	1,757	1,823	1,896	1,972	2,051	23,193 Tentative Alternative Minimum Tax
Tax (Higher of Regular or AMT)	92	0	0	0	43	99	215	279	347	419	1,654	1,792	1,931	2,087	2,248	2,416	2,547	2,650	2,757	2,865	2,986	3,099	3,223	3,352	3,486	48,539 Tax (Higher of Regular or AMT)
AMT Credit Used	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0 AMT Credit Used
Production Credit Used	0	0	0	0	0	0	0	0	0	1,159	1,215	1,836	854	903	1,911	1,885	1,186	1,152	1,186	1,227	1,276	1,257	0	0	0	14,480 Production Credit Used
Tax Payment	92	0	0	0	43	99	215	279	347	419	495	575	901	1,231	1,536	1,682	1,463	1,523	1,682	1,685	1,733	1,823	1,896	1,940	3,486	34,606 Tax Payment
Expired, Unused Production Credit	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0 Expired, Unused Production Credit

Mr. KOPETSKI. We have from Geothermal Resources Association, the chairman, Thomas Hinrichs.

STATEMENT OF THOMAS C. HINRICHS, CHAIRMAN, GEOTHERMAL RESOURCES ASSOCIATION, AND VICE PRESIDENT, MAGMA POWER CO., SAN DIEGO, CALIF.

Mr. HINRICHS. Mr. Chairman and members of the subcommittee, I also want to thank you for the opportunity to testify before you today on legislation which would permit the renewable energy investment tax credits presently available to businesses as offsets to the regular tax to be applied against the alternative minimum tax.

My name is Thomas Hinrichs, and I am vice president of the Magma Power Co., and I wish I could take credit for bringing some San Diego weather to Washington. It has just been lovely. Our operations are totally dedicated to geothermal development.

Today, however, I am testifying as chairman of the Geothermal Resources Association. The GRA consists of 15 members involved in the development of geothermal resources. We focus on issues of interest to geothermal development, and, of course, a major issue is the ability to utilize the recently extended tax credits for geothermal property.

It is, therefore, not surprising that we support legislation which would provide for the application of the tax credits against the AMT, which is almost always triggered in the cases of companies involved in geothermal development. We are a highly capital-intensive industry.

Prior to commenting with more specificity on AMT relief, however, I would like to put geothermal resources in perspective. Put succinctly, the geothermal resource has significant potential as a secure energy source from the national security standpoint and is compatible with the environment.

Geothermal energy is environmentally benign, a fact which is of particular importance in an era of global warming stemming from excessive carbon emissions and air pollution caused by other harmful pollutants being emitted into the atmosphere.

A state of the art flash steam geothermal plant emits a small percentage of pollutants discharged by fossil fuel plants and emits none of the pollutants causing smog and acid rain. Binary plants such as those operating in California and Nevada produce essentially no air emissions of any kind. Moreover, geothermal has significant potential which could be realized if appropriate incentives are available.

At present, only approximately 2,800 megawatts have been developed, with some estimates placed at no more than 10 percent of the clearly identified resource and a minuscule portion of the predicted range of geothermal potential. However, 2,800 megawatts of development makes a difference in meeting our energy needs, for each 100 megawatt plant can support the energy needs of a community of 100,000.

Most recently, growth in the geothermal area has been restricted by four major factors:

One, oil and gas prices have been low, and since, in effect, renewables generating electricity compete with oil and to an even greater

extent with gas, the present investment and development potential has been limited.

Two, favorable contracts with utilities as promoted by States, particularly in California, the so-called standard offer contracts were unavailable, and there are no comparable incentives for renewables.

Three, the major Federal tax incentive, geothermal energy tax credit, had in the past few years been in jeopardy on several occasions, and the short-term extensions which followed precluded the tax credits from being considered in long-range planning, investment or development of geothermal resources.

And, four, even though the credit was available, the benefits of the geothermal tax credit have been limited because of restrictions preventing its use against AMT.

Mr. HINRICHS. Now, we hold out some hope for resurgence of geothermal development. First, natural gas prices, although still low, have been increasing which, in turn, will make renewables more attractive.

Second, while favorable contracts are still a thing of the past, several States, in developing additional power needs, have specified certain set-asides or allotments for renewables. For example, it is expected that California utilities will put out to bid up to 300 megawatts of new sources of power generation by renewables to be placed in service in the 1997 to 1999 period. Yesterday the California Public Utilities Commission acted on a decision to direct the utilities to start that process on August 4.

Third, the tax credits for solar and geothermal property were made permanent as part of the Energy Policy Act of 1992. We thank this subcommittee and the full Ways and Means Committee for your efforts in this regard.

This leaves a fourth and final remaining impediment—the inability of geothermal developers to apply the tax credits against the AMT and hence make practical use of intended incentives. New sources of electrical generation are being acquired through a bidding process. If the inability to apply tax credits against the AMT was corrected by legislation, it would result in lower and newer energy prices being put forward in this bidding process.

H.R. 2026 introduced by Congressman McDermott, provides that tax credits could be applied up to 25 percent of the AMT. While we think the bill is a fine start, we urge that full utilization of the tax credits be permitted as we understand is provided in the other member proposal introduced by Congressman Thomas, relating to AMT for renewables listed in the subcommittee's press release of June 2, 1993. Full utilization is a catalyst needed spur renewable development.

Thank you very much for the opportunity to express our views.

Mr. KOPETSKI. Thank you, Mr. Hinrichs.

[The prepared statement follows:]

STATEMENT OF THOMAS C. HINRICHS
ON BEHALF OF THE GEOTHERMAL RESOURCES ADMINISTRATION

Mr. Chairman and Members of the Committee, I want to thank you for the opportunity to testify before you today on legislation which would permit the renewable energy investment tax credits ("tax credits") presently available to businesses as offsets to their regular tax, to also be applied against the alternative minimum tax ("AMT").

My name is Thomas C. Hinrichs and I am Vice President of Magma Power Co., whose operations are totally dedicated to geothermal development. Today, however, I am testifying as the Chairman of the Geothermal Resources Association ("GRA"). The GRA consists of 15 members involved in the development of geothermal resources. We focus on issues of interest to geothermal development and, of course, a major issue is the ability to utilize the recently extended tax credits for geothermal property. It is therefore not surprising that we support legislation which would provide for application of the tax credits against the AMT, which is almost always triggered in the case of companies involved in geothermal development.

Prior to commenting with more specificity on AMT relief, however, I would like to put geothermal resources in perspective. Put succinctly, the geothermal resource has significant potential, is a secure energy source from a national security standpoint, and is compatible with the environment.

Geothermal energy is environmentally benign, a fact which is of particular importance in an era of global warming stemming from excessive carbon emissions and air pollution caused by other harmful pollutants being emitted into the atmosphere. A state-of-the-art flash steam geothermal plant emits a small percentage of pollutants discharged by fossil fuel plants and emits none of the pollutants causing smog and acid rain. Binary plants such as those operating in California and Nevada produce essentially no air emissions of any kind.

Moreover, geothermal has significant potential, which could be realized if appropriate incentives are available. At present, only approximately 2,800 megawatts have been developed which some estimates place at no more than 10% of the clearly identified resource and a minuscule portion of the predicted range of geothermal potential. However, 2,800 megawatts of development makes a difference in meeting our energy needs, for each 100 megawatt plant can support the energy needs of a community of 100,000.

Most recently, growth in the geothermal area has been restricted by four major factors: (1) oil and gas prices have been low and since, in effect, renewables generating electricity compete with oil and, to even a greater degree with gas, the present investment and development potential has been limited; (2) favorable contracts with utilities as promoted by states, particularly in California -- the so-called "standard offer" contracts -- were unavailable and there were no comparable incentives for renewables; (3) the major federal tax incentive -- the geothermal energy tax credit -- had, in the past few years, been in jeopardy on several occasions and the short-term extensions which followed precluded the tax credits from being considered in the long-range planning, investment, or development of geothermal resources; and (4) even though the credit was available, the benefits of the geothermal tax credit have been limited because of restrictions preventing its use against the AMT.

Now, we hold out some hope for a resurgence of geothermal development. First, natural gas prices, although still low, have been increasing which, in turn, will make renewables more attractive. Second, while favorable contacts are still a thing of the past, several states, in developing additional power needs, have specified certain "set-asides" or allotments for renewables. For example, it is expected that California

utilities will put out to bid up to 300 megawatts of new sources of power generated by renewables to be placed in service in the 1997-99 period. Third, the tax credits for solar and geothermal property were made permanent as part of the Energy Policy Act of 1992. We thank this Subcommittee and the full Ways and Means Committee for your efforts in this regard. This leaves the fourth and final remaining impediment -- the inability of geothermal developers to apply the tax credits against the AMT and hence make practical use of the intended incentive. New sources of electric generation are being acquired through a bidding process. If the inability to apply tax credits against the AMT was corrected by legislation, it would result in lower renewable energy prices being put forward in the bidding process.

H.R. 2026, introduced by Congressman McDermott, provides that the tax credits could be applied against up to 25 percent of the AMT. While we think the bill is a fine start, we urge that full utilization of the tax credits be permitted as we understand is provided in the other Member proposal, introduced by Congressman Thomas, relating to AMT for renewables listed in the Subcommittee's press release of June 2, 1993. Full utilization is the catalyst needed to spur renewable development.

Ironically, twice in the last three years the oil and gas industries have received relief from the AMT in tax legislation. Coupled with other tax breaks enjoyed by the oil and gas industries, renewables remain some distance from reaching the proverbial "level playing field."

Permitting the tax credits to be applied against both the regular tax and the AMT will enable renewable projects to compete with conventional fossil fuels in the bidding for new utility projects. And such successful bidding will result in the twin national benefits of energy independence and environmental enhancement.

The tax credits can be the single-most effective federal program to promote renewable energy, stimulating investments and enabling the technology to develop and improve. With the tax credits extended, the geothermal industry will be able to compete in the bidding process for new plants, continue technology development and bring new environmentally beneficial projects on line, provided it can, in fact, fully utilize the tax credits. Thus, we strongly urge this Subcommittee and the Congress to support the full utilization of the energy tax credits against the AMT.

Thank you for permitting me to present the views of the GRA. I would be pleased to answer any questions you might have.

STATEMENT OF STEPHEN F. JOHNSON, EXECUTIVE DIRECTOR, WASHINGTON PUBLIC UTILITY DISTRICTS' ASSOCIATION, ON BEHALF OF AMERICAN PUBLIC POWER ASSOCIATION

Mr. KOPETSKI. From the great State of Washington, where we have a very esteemed member on this panel, is Stephen Johnson, who is from the Washington Public Utility District Association.

Welcome, Mr. Johnson.

Mr. JOHNSON. Thank you.

Good afternoon, Mr. Chairman, members of the subcommittee. I am Stephen Johnson, executive director of the Washington Public Utilities District Association. The public utility districts provide electricity on a not-for-profit basis to 1.5 million people in the State of Washington. I am appearing today on behalf of the American Public Power Association, a national service organization, representing more than 1,750 consumer-owned electric utilities throughout the United States as well as the PUD Association.

The focus of my testimony is H.R. 2026, the Renewables and Energy Efficiency Incentives Act of 1993 and particularly section 302, title 3 of that bill. As is apparent from its title, H.R. 2026 is designed to encourage energy efficiency and the production and use of renewable energy. We share this goal.

The Oak Ridge National Laboratory's report for the years 1989–91, reports public power saved more energy at less cost than private utilities. Public power has an excellent record in the promotion of energy efficiency and renewable resources.

My own organization created a new joint operating agency called the Conservation and Renewable Energy System to finance and develop these resources. Theirs is the first joint operating agency of this type in the Nation. By the way, Oregon is organizing the second with our assistance through the League of Oregon Cities.

What 2026 does is use the Tax Code to promote energy efficiency and renewable energy sources. Titles 1 and 2 provide tax incentives to private utilities to develop these resources. I don't intend to address at length those provisions, but since it has been mentioned, the 13-year retroactive deduction for conservation investments may be a necessary perfection in the Tax Code. However, as an incentive, it won't create 1 more kilowatt hour of energy reaching back and making those payments, and perhaps ought to stand alone and be separate from those provisions.

Our main concerns, however, are with title 3, section 302, which finances these incentives by taking away from public power the use of tax-exempt financing for coal, oil, and nuclear plants.

Our specific concerns with section 302 are: One, that it is inconsistent with the principles of federalism in that it dictates to local governments how they will serve their citizens. Tax-exempt financing has traditionally been extended to all activities undertaken by State and local governments, so as long as the facilities are owned and operated by the government and the benefits are provided to all citizens.

State and local governments are responsible for providing public services, therefore, decisions about these public facilities are best left to the State and local officials.

Second, section 302 also raises questions of fairness in providing benefits to private power at the expense of public power, while less than 10 percent of coal oil and nuclear facilities are owned by public systems is about 7 percent. More than 80 percent are owned by private utilities.

So you are going to a very small segment of the industry to get the money to fund incentives in a very large segment of the industry.

Third, section 302 presents a host of practical and administrative problems as well. For instance, the financing of dual-fuel facilities, almost all gas-fired combustion turbines have standby oil, a very necessary part of their operation. The financing of environmental improvements to existing plants in the original draft of this bill is not provided for scrubbers on coal plants and such.

But beyond that, this makes judgments about new technologies and may discourage those that have significant environmental benefits. For example, Energy Daily reports this week on the success of a new coal gas-fired fuel cell, an investment which section 302 would not allow with tax-exempt financing. So 302 is flawed in attempting to determine for local governments how they meet their environmental and energy needs.

It is similar in a way to the 1978 Fuel Use Act, which restricted the use of natural gas for electric generation. It turns out that was a mistake. Should Congress make these decisions or should they be made on the local level, using sound planning principles, like integrated resource planning, something that American Public Power Association has pioneered in, where all resources are weighed against each other. We made some serious mistakes in the past, where we bet on one resource or some authority designated one resource as the resource that we ought to generate electricity with. I don't think we want to repeat that mistake.

In conclusion, we support the goals of H.R. 2026, increased use of energy efficiency and renewables are clearly in the national interests but these goals cannot be achieved without taking into account the relative roles of the Federal local and State Governments, as well as questions of fundamental fairness among sectors of the industry. Section 302 fails these tests and should not be endorsed by this committee.

Thank you, Mr. Chairman. I appreciate your indulgence.

Mr. KOPETSKI. Thank you Mr. Johnson.

[The prepared statement and attachments follow:]

Statement of
Stephen F. Johnson, Executive Director
Washington Public Utility Districts' Association
Presented on Behalf of
American Public Power Association
Before the
Committee on Ways and Means
Subcommittee on Select Revenue Matters
June 24, 1993

Mr. Chairman, members of the subcommittee, I am Stephen F. Johnson, executive director of the Washington Public Utility Districts' Association. The public utility districts in Washington provide electricity to more than 1.5 million people. My association is an affiliate member of the American Public Power Association, and I serve as a member of APPA's Advisory Committee. APPA is the national service organization representing more than 1,750 local publicly owned electric utilities throughout the United States. Collectively, public power systems provide electric service to one of every seven Americans. I am appearing today on behalf of both APPA and the Washington Public Utility Districts' Association. The focus of my testimony today is H.R. 2026, the "Renewables and Energy Efficiency Incentives Act of 1993," and particularly section 302 of that bill.

As is apparent from the title, H.R. 2026 is designed to encourage energy efficiency and the production and use of renewable energy. The sponsor of this legislation, Rep. Jim McDermott (D. WA) is a tireless advocate for energy efficiency and renewable energy. Both the Washington PUD Association and APPA share Rep. McDermott's enthusiasm and commitment to wise use of energy and advocacy of technology to increase the use of renewable energy resources. Indeed, public power has a laudable record in this regard.

For example, APPA has long backed the concept of integrated resource planning, i.e. examination of the spectrum of possibilities from demand-side management to cogeneration and employment of solar, wind, biomass, geothermal and hydropower. Oak Ridge National Laboratory reported recently on the effects and costs of electric utility demand-side management programs from 1989 to 1991. The lab pointed out: "The investor-owned utilities (IOUs) spent a larger percentage of their revenues, on average, than did the public utilities (which include federal, state, municipal, and cooperative utilities). On the other hand, the publics reported larger percentage reductions in demand and energy than did the IOUs." In other words, public power saved proportionately more energy at less expense than private power companies.

Many publicly owned electric utilities are involved in the use of renewable resources to produce power, including a major wind project underway in the state of Washington, plus hydroelectric projects such as those operated by Seattle City Light. APPA was instrumental in putting together a new industry-wide Utility Photovoltaic Group dedicated to advancing solar production of electricity, and the Association is a partner in the Solar Hot Water Utility Interest Group, which is encouraging utility support for solar hot water installations.

The Washington PUD Association and its members also have a solid record in support of energy conservation, efficiency and the development of renewable energy sources. Since 1989 PUDs have committed to engage in least cost/integrated resource planning, making conservation and renewable resources our highest priorities. Recently, the Washington PUDs established a new Joint Operating Agency exclusively to finance and develop conservation and renewable energy resources for PUDs and municipalities.

The Conservation and Renewable Energy System (CARES) is the first joint operating agency of its kind in the nation and is currently developing a 27 megawatt wind farm near Goldendale, Washington and financing extensive energy efficiency programs together with the Bonneville Power Administration.

It should be clear from these examples that we share Rep. McDermott's goals. However, H.R. 2026 proposes to use the Internal Revenue Code as the sole means of advancing these goals. Public power systems are not-for-profit enterprises of state and local governments and are exempt from paying federal income taxes. Thus, none of the tax incentives provided in titles I or II of H.R. 2026 would be of any benefit to public power. For this reason, we are not well situated to judge their effectiveness in promoting these goals. (We do note that one particular provision, section 202 relating to deductions for energy conservation expenditures by investor-owned utilities, is retroactive to 1980. We question whether this 13-year retroactive provision is necessary to promote future energy conservation expenditures.)

Our concern with this legislation, however, is not based on the incentives it provides, but on how they would be financed. While Titles I and II are carrots used to encourage certain energy efficiency and renewable energy investments, Title III is the stick. It is intended to discourage certain energy investments through changes in the Internal Revenue Code, and use money saved from these changes to fund the incentive programs in the first two titles.

One of these changes, section 302, would repeal of the tax-exempt status of bonds used to finance certain electric generating facilities, specifically those facilities using nuclear, coal, oil and other petroleum products. We strongly oppose this section of the legislation. This provision is inconsistent with principles of federalism that have, for the most part, guided Congress in setting the ground rules for tax-exempt bond financing. It is unfair to local, publicly owned electric utilities. As a "stick" to alter behavior, it will have at best only marginal effect when considered in the context of the overall national energy picture. It will alter the competitive balance between public and private power. And, if implemented, it will create practical and administrative problems.

Federalism and Tax-Exempt Financing

Traditionally tax-exempt financing has been permitted for all activities undertaken by a state or local governmental entity so long as the facilities financed with tax-exempt bonds are owned and operated by that entity and the benefits of the facility are provided to all of its citizens. Section 302 of H.R. 2026 rejects this approach. It would make tax exempt financing of state and local governments -- entities acting on behalf of their constituents and providing public services to their constituents -- contingent on whether the activity to be undertaken had received a Congressional stamp of approval. Such intrusive action by the Congress is totally inconsistent with the principles of federalism.

Under our federal system, responsibility is shared between federal, state and local governments. One of the most outstanding attributes of this form of government is the preservation of the rights of each of these governments to act on behalf of its own constituents without undue interference. One form of interference is federal taxation of interest on debt instruments of state and local governments. For decades, the courts considered such taxation unconstitutional. While the courts have recently rejected the constitutional underpinnings of such tax immunity, the principal continues to make sense.

Decisions made by state and local governments regarding what services they will provide to their citizens and what facilities they will construct, own and operate, should be left to those state and local governments. They should not be skewed by Congressional determinations of what activities a majority of the members of Congress at any particular point in time conclude may be funded through tax-exempt bonds and what may not. Congress cannot possibly have the wisdom to know what is in the best interest of the citizens of the more than 80,000 governmental jurisdictions throughout the country. Part of the genius of our federalist system lies in the recognition of this fact. If Congress begins to micro-manage the economy in the fashion of a centralized economic planner, it will

limit the flexibility of state and local governments. And when Congress makes the wrong choice, the effects of centralized economic planning will be felt throughout the entire economy.

This encroachment on the principle of federalism lies at the very heart of our objection to section 302. That section would have Congress reach into the decision-making process of local public power systems, guiding the energy policy choices of local governments in a way that may seem appropriate this week but may be totally inappropriate next week or next year. And of course there is no reason to stop at energy policy. Following the precedent of section 302, Congress could set policy in a broad range of other areas from transit to schools. It is no more appropriate for Congress to micro-manage local communities in the manner proposed in section 302 of H.R. 2026 than it would be for Congress to determine that public transit systems may not use tax-exempt bonds to finance mass transit vehicles powered by internal combustion gasoline powered engines or that local school districts may not use tax-exempt bonds to finance public school heating systems fueled by petroleum products.

Fairness

Section 302 in juxtaposition to incentives provided in Titles I and II raises questions of fairness. Titles I and II provide tax incentives to private, for profit entities including investor-owned utilities. However, nothing in Titles I and II benefit public power systems. Nevertheless, the Title I and II programs are paid for in large part by the elimination of tax exempt financing now available to public power systems. Thus, stripped to its most basic form, private power companies gain while public power systems and their consumer owners lose.

This equation of private gain and public loss might be based on the assumption that only public power systems receive benefits under the tax code. If that were the case, then one way to pay for tax incentives available to private power would be to take away benefits from public power. But the assumption is not correct. As is clear from the attached article, private power companies have enjoyed and continue to enjoy enormous benefits under the tax code. (Another benefit not noted in the article is the ability of investor-owned utilities to tag the U.S. Treasury for a substantial portion of failed projects. The most recent example of this is the tax write-off provided Long Island Lighting Company for its failed investment in the Shoreham Nuclear Project.)

While some of these benefits, for example the investment tax credit, no longer exist, they continue to receive substantial benefits from accelerated depreciation schedules (i.e. schedules that bear no relationship to the useful life of the facility being depreciated). Investor-owned utilities are currently holding $57.3 billion in accelerated depreciation accounts. In essence, these funds are simply interest free loans from the U.S. Treasury. The legislation does not propose to reduce or eliminate this IOU subsidy, a large part of which goes to finance coal, petroleum, and nuclear power generation. We would suggest that it would be far more equitable to reduce this subsidy and use funds saved to pay for the other subsidies that would be made available to the IOUs by H.R. 2026.

Energy Investment Decisions

An alternative explanation for the intent of section 302 is that it is designed to prevent any tax benefits from flowing to investments in nuclear, coal and oil generation facilities. By eliminating these benefits, presumably utility behavior would be altered -- that is, utilities will invest in facilities that do not use these disfavored fuels.

If that is the rationale for section 302, it badly misses the mark. For the most part, the proposal targets facilities built by issuers of tax-exempt bonds, i.e., public power. (The proposal would eliminate tax-exempt financing under the "local furnishing" provision of the Code as well. That provision benefits a handful of investor owned

utilities.) Over 80 percent of the nation's conventional steam generating capacity -- most of which is fueled by coal, oil and other petroleum products -- are owned by investor-owned utilities, while less than ten percent are owned by public power systems. And over 90 percent of the nation's nuclear generating capacity is owned by private systems, while only 4 percent is owned by public power. It is also ironic that collectively, public power systems rely more heavily on natural-gas fueled facilities and hydroelectric projects than do investor owned utilities. (The attached chart shows the generation capacity of the electric utility industry and the various segments of the industry.)

Whether the provision will alter public power's investment decisions is unclear. What is clear is that it will increase public power's cost of capital and thereby increase public power's costs. Assuming section 302 does shape energy policy choices of public power, based on the figures above and the fact that public power serves only 15 percent of the population, the energy policy decisions of the largest segment of the industry will not be affected in the least.

Clearly, if the desire is to affect utility behavior, it would make far more sense to reduce the tax code benefits that flow to investor owned utilities, then use the funds from altering those programs to finance the IOU incentives contained in Titles I and II of H.R. 2026.

Practical and Administrative Problems

The proposal raises a number of serious practical and administrative problems. For example, how would a public power system finance a dual fuel (coal and gas) facility? What about a coal gas generation unit? In fact, if even a very small percentage of an issue is used on a facility that uses one of the disfavored fuel sources, the entire bond issue would be taxable. This would be the case even if most of the bond proceeds were targeted for energy conservation or a renewable energy facility.

Refurbishment, repowering and refinancing of existing plants would also be subject to the limitations of section 302 of H.R. 2026. Consumers have saved hundreds of millions of dollars by refinancing high cost debt with lower cost debt. As we read this provision, tax exempt bonds would not be available to refinance debt of existing coal, oil, petroleum products and nuclear fuel plants. In such cases, the provision will not affect future energy choices, it will simply make power from existing facilities more expensive.

Further, the provision applies across the board, regardless of the availability, or lack thereof, of alternative sources of power. The provision may have minimal effect on a region rich in hydropower or one having access to natural gas. But there are regions in which neither energy source is readily available. Energy conservation and renewables might not be capable of meeting electricity demand. Coal may be the only available resource. Is it sound energy policy or in the interest of consumers to deny state and local governments the use of tax-exempt bonds to develop certain types of facilities when their power supply needs can be met only by those types of facilities?

Competitive Balance

Section 302 would not "level the playing field" in financing costs between public and private utilities as some have suggested. Instead, it will have the opposite effect -- altering the competitive balance between public and private power in this country. The proposal takes away low cost financing capability of consumer owned electric utilities while giving new financing advantage to IOUs. Further, even if the provision were to equalize the cost of capital for public systems and IOUs, they could take advantage of other tax code provisions such as accelerated depreciation to obtain financial benefits not available to not-for-profit and hence non-taxable public power systems.

Development of New Technologies

Some of the best prospects for technologies that will give us economic energy and environmental enhancement involve use of coal, which represents our largest domestic fuel for power production. They include fluidized bed combustion, integrated gasification-combined cycle, and fuel cells.

On Tuesday, June 22, The Energy Daily reported on advances in the molten carbonate fuel cell. A stack of molten carbonate fuel cells reached 50 percent efficiency during a 10 day trial run. As stated in The Energy Daily, "the trial run adds credence to the fuel cell industry's claims of substantially higher efficiency levels in tandem with minimal environmental damage." The same article notes that Energy Research Corp., the developer of the fuel cell, is working on a combined cycle project that will incorporate a 2.5 MW molten carbonate fuel cell plant that will be powered by coal gas. Assuming this technology becomes commercial, section 302 would prevent public power systems from financing such fuel cells through the issuance of tax exempt bonds. Again, it would be ironic if public power, a leader in the nationwide effort to commercialize fuel cells in large part because of their environmental benefits, could not finance such projects using tax exempt bonds.

Section 303

I would also like to note our objection to section 303 of H.R. 2026. That section would eliminate the tax exempt status of rural electric cooperatives. Rural electric cooperatives, like public power systems, operate on a not-for-profit basis. Since taxes are imposed on profits, there would seem to be little gain to the U.S. Treasury from changing the tax status of these cooperatives. It is not clear what specific energy policy would be advanced from the enactment of this section.

Conclusion

APPA and the Washington PUD Association support the goals of H.R. 2026. Increased use of renewable energy resources, including hydropower, and ensuring efficient use of existing facilities and resources, are clearly in our national interest. But these goals cannot be accomplished solely through the tax code. Indeed, an entire Congress was spent on developing and refining our national energy policy to set up various programs to advance energy efficiency and renewable resources. Nor can these goals be achieved without taking into consideration other important policies such as the relative roles of the federal government and state and local governments within our federalist system and questions of fundamental fairness among sectors of the industry. Section 302 fails these tests and should not be endorsed by this Committee.

THE SUBSIDY DEBATE

A narrow look at utility financing could cripple competition.

by John Kelly

To grasp an idea correctly, it is usually necessary to grasp it as a whole. This notion seems to have no standing in the debate over the relative tax status of public and private power systems. And ignoring it has produced a series of economically perverse federal policies affecting the nation's electric power industry. These policies are the result of a narrow focus on federal revenue losses from tax-exempt, public purpose financing; the failure to acknowledge the sizeable tax subsidies private systems continue to receive; and a general lack of knowledge of the economic and institutional impediments that stifle competition in the electric power industry.

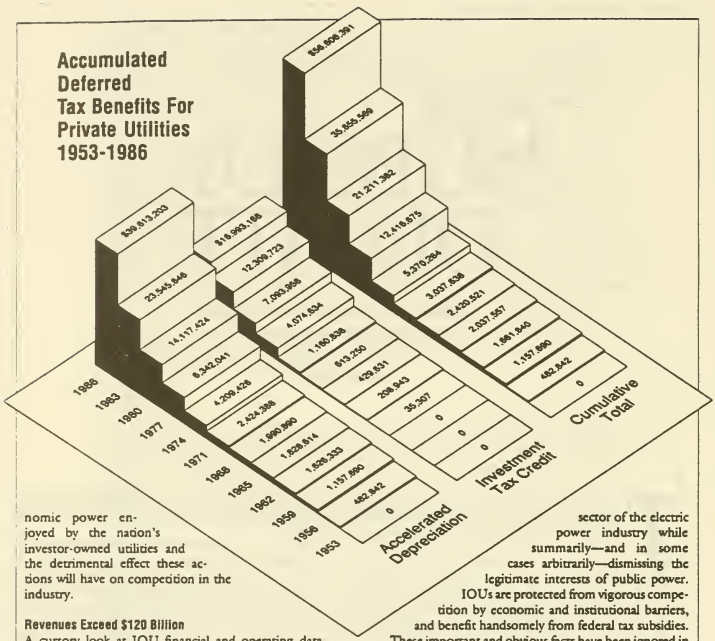
A report prepared for the American Public Power Association by consultant Alan P. Laskin provides estimates of the multibillion dollar federal tax subsidies investor-owned utilities have received from their use of the accelerated depreciation and investment tax credit provisions of the federal tax code. Laskin estimated that for the years 1954 through 1986, IOU revenues could have been reduced by $56.9 billion had the benefits of these subsidy provisions been passed through to ratepayers. This means electric rates of IOU customers could have been reduced an average of 3.5 percent per year during the 23-year period.

The Laskin report was commissioned to impress upon policymakers that tax preferences to IOUs exist and to highlight the magnitude of these preferences, notwithstanding changes brought about by the Tax Reform Act of 1986. The report also demonstrates the inconsistency and inequity of narrowly focusing on public power's access to tax-exempt financing.

In each of the past two years Congress enacted legislation that weakened the competitive position of public power in particular and competition in the electric power industry in general. The Tax Reform Act of 1986 imposed costly requirements on public power systems, severely restricting opportunities to share ownership and benefits of power plants with private utilities. The 1986 law also imposed restrictions on advance refunding and arbitrage earnings for tax-exempt bonds. In 1987, a provision of the Omnibus Budget Reconciliation Act barred use of tax-exempt financing for purchase of electric output facilities unless the financing fell under state ceilings for private purpose bonds. The 1987 restriction applies to public power systems established after Oct. 13, 1987, and it erects a costly barrier to creation of new public power systems. In addition, Congress in 1986 revoked public power's preference in hydro relicensing, thereby eliminating competition for licenses on established hydro projects.

Currently the Federal Energy Regulatory Commission is, in the name of competition, proposing, in one of three proposed rule makings, to restrict public power from competing in bulk power supply bidding programs.

These congressional and regulatory actions do not take cognizance of the substantial federal tax benefits and eco-



nomic power enjoyed by the nation's investor-owned utilities and the detrimental effect these actions will have on competition in the industry.

Revenues Exceed $120 Billion

A cursory look at IOU financial and operating data reveals their substantial economic power. In 1986 IOU retail revenues exceeded $120 billion and represented 79 percent of all retail revenues in the industry. IOU retail kWh sales accounted for 77 percent of all retail kWh sales in the industry. And IOU retail revenues were almost seven times those of public power systems. The relative economic influence of IOUs is even greater in certain states and regions. Individual IOUs possess financial and public relations resources that dwarf those of local communities that currently provide their own electric service or desire to do so in the future.

Public power, with 13 percent of the industry's revenues and 15 percent of kWh sales, is the major competitor to investor-owned systems. By severely restricting public power's access to tax-exempt financing while allowing IOUs to continue to benefit mightily from the federal tax system, Congress is legislating competition out of the electric power industry. Many policymakers are uncritically accepting the self-serving arguments of the largest and most powerful sector of the electric power industry while summarily—and in some cases arbitrarily—dismissing the legitimate interests of public power. IOUs are protected from vigorous competition by economic and institutional barriers, and benefit handsomely from federal tax subsidies.

These important and obvious facts have been ignored in recent years, and the result has been economically perverse legislative and regulatory policies.

Which Segment Favored?

In his report, *Accelerated Depreciation and the Investment Tax Credit: How Big is the Subsidy for Investor-Owned Utilities?*, Alan Laskin noted that at the center of almost every policy debate on the electric utility industry is the question of which sector—public, private or cooperative—receives more favorable government treatment. Laskin focused on the benefits received by IOUs from their use of the accelerated depreciation and investment tax credit (ITC) provisions of the federal tax code. The ITC was repealed by the Tax Reform Act of 1986, but utilities still benefit from deferred credits earned in previous years. These provisions have been particularly favorable to IOUs because of the capital-intensive nature of the electric power industry. The main questions Laskin addressed were: "How big a subsidy have these two

tax provisions represented for the private utility industry" and "What would IOU revenue requirements have looked like if accelerated depreciation and investment tax credits had not been available?" He answered the questions by assuming that the benefits of the subsidies had been passed through to IOU ratepayers.

Laskin defined a subsidy as the difference between the price of a good or service with and without some preferential government policy. Consequently, it is not sufficient to simply look at the amount of deferred taxes foregone by the federal Treasury to determine the size of a subsidy; it is necessary to look at the impact on prices of eliminating a subsidy. In doing this, however, other important variables should be held constant. The two variables Laskin holds constant are the utilities' net income and cash flow. Eliminating the subsidy would have a significant secondary effect on cash flow, which would be reflected in the price of electricity.

The benefits IOUs derive from accelerated depreciation and ITC come in the form of reduced and deferred tax liabilities. The accelerated depreciation provision of the federal tax code allows them to collect estimated future tax expenses from ratepayers in current periods. The estimated amounts of future-year taxes—taxes collected from ratepayers but not paid to the federal Treasury—are referred to as deferred taxes. The deferred taxes from accelerated depreciation are treated as current period expenses and accumulate in a deferred income tax account. At the end of 1986 IOUs had $39.6 billion in this account.

For federal income tax purposes, a utility was allowed to deduct from its current tax bill a percentage of the cost of certain capital assets acquired or put into service in a given year.

"For ratemaking purposes, however," Laskin noted, "the tax benefits of the ITC were normalized so that a pro rata share of the credit was passed through to ratepayers each year over the lives of the IOUs' assets for which the credit was received rather than in the year the benefit was received."

IOUs still benefit from the repealed provision because the accumulated deferred ITC amounts on their books are returned to ratepayers gradually over the lives of specific assets. At the end of 1986 there was $17.0 billion in this account.

In addition, private power companies continue to benefit from the unamortized investment tax credit because they are allowed to earn a rate of return on them. This benefit will last for decades, predicted the National Association of Regulatory Utility Commissioners. "With the demise of the ITC, one is tempted to think the problem has been removed," NARUC said. "Such is not the case."

At the end of 1986 investor-owned systems would have had to replace $56.6 billion. This amount is, in effect, an interest-free loan they enjoyed from their use of deferred taxes.

Ratepayers Provide $8.1 Billion

Laskin made an initial estimate of the IOU subsidy from accelerated depreciation and ITCs by calculating the impact on their revenues if these benefits were flowed through to IOU ratepayers. For example, for 1986 deferred taxes totaled $7.7 billion—$6.9 billion from accelerated depreciation and $800 million from ITCs. Laskin estimated it would

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Resistance to a citizen effort to bring public power to Chicago was the impetus for the 1987 law restricting use of tax-exempt financing to acquire electric utility facilities of private companies. But the debate that propelled passage of the 1987 financing restrictions ignored subsidies to investor-owned utilities.

The economic perversity of the 1987 restriction is readily apparent from a comparison of the electric rates of Commonwealth Edison Co., the IOU serving Chicago, and other utilities. In 1986 Commonwealth Edison's average residential rate was 10.6 cents per kWh. Average residential rates were 7.5 cents per kWh for all other private power companies in Illinois and 6.6 cents for public systems in Illinois. These and national average rates are summarized here:

- Commonwealth Edison 10.6
- Private systems, national 7.7
- Private systems, Illinois 7.5
- Public systems, national 5.9
- Public systems, Illinois 6.6

It should not be surprising that many citizens in Chicago are dissatisfied with Commonwealth Edison's performance and want a change. The 1987 restriction, under the pretext of providing a more competitive environment, weakened the competitive threat to Commonwealth Edison—a utility with an electric rate that is 61 percent higher than its public power competitors in the state and 41 percent higher than the average for other private systems in Illinois.

In a competitive market these disparities would vanish in short order. But in a market dominated by an IOU with substantial economic and political power, the disparities persist. It would seem that the persistent disparities would at least raise doubts, if not provide convincing evidence, that effective competition is absent. □

cost utilities $900 million in financing costs if their $7.7 billion of deferred tax benefits were flowed through to ratepayers. However, this added cost would be more than offset by $1.3 billion in lower utility revenue requirements resulting from lower before-tax income. After accounting for these effects, private companies could have reduced their rates by a net amount of $8.1 billion while maintaining the same net income and cash flow as before the flow-through to ratepayers of the deferred tax benefits.

The accumulated subsidy for the 1954-1986 period is calculated by totaling the individual annual estimates. Accumulated deferred taxes total $56.6 billion, and the total amount of additional financing costs are $7.2 billion. For these years, revenues could have been reduced by $7.5 billion because of lower taxes resulting from lower before-tax income. The net subsidy for these years is $56.9 billion.

Debate's Tenor Uneven

Another approach to quantifying the benefit to investor-owned systems of the deferred tax provisions of the federal tax code is to focus on the amount their financing costs would increase if they did not have the use of the accumulated deferred taxes from accelerated depreciation and ITCs. For example, the deferred tax dollars could just as easily have been paid to the federal Treasury, as would have happened in the absence of the deferred tax provisions of the tax code. This approach would result in a different subsidy estimate. At the end of 1986 investor-owned systems would have had to replace $56.6 billion. This amount is, in effect, an interest-free loan they enjoy from their use of deferred taxes. Estimating the IOU subsidy from this perspective is particularly useful in the continuing debate over the relative tax benefits public and private power receive because it highlights the uneven tenor of the debate.

IOU representatives continually claim that public power rates would be higher if public power did not have access to tax-exempt financing. While this is true, it is incorrect to conclude that public power has an unfair advantage over investor-owned systems. Moreover, it is unfair to focus on this circumstance affecting public power rates while ignoring the obvious fact that the rates of IOUs would be higher if they did not enjoy billions of dollars of interest-free capital from their use of the deferred tax provisions of the federal tax code.

Many policymakers are uncritically accepting the self-serving arguments of the largest and most powerful sector of the electric power industry while summarily—and in some cases arbitrarily—dismissing the legitimate interests of public power.

Taxes Never Paid

IOUs had the use of approximately $52.8 billion in interest-free capital available to them during 1986 to finance their operations. If they were to raise $52.8 billion in debt and equity markets, it would have cost them approximately $6.2 billion. This is a conservative estimate based on the cost of capital figure of 11.7 percent for 1986 in the Laskin report. The $6.2 billion in increased financing costs would have raised the rates of IOUs by approximately 4 percent in 1986. The industry itself estimated that its financing costs would have increased by $6 billion in 1984 if it were deprived of the use of $34 billion in deferred taxes.

A more popular approach used to estimate federal tax subsidies is to focus on the revenue loss to the Treasury resulting from federal tax preferences. These losses are commonly referred to as tax expenditures. Using this approach, the subsidies to IOUs from accelerated depreciation and ITCs can be estimated from the deferred tax accounts of the utilities' financial statements: $7.7 billion for 1986, and $56.6 billion for the 1954-1986 period. These amounts were the starting point of the Laskin methodology, and are close to his final estimates. The tax expenditures approach and the Laskin approach yield similar estimates because each measures the same concept.

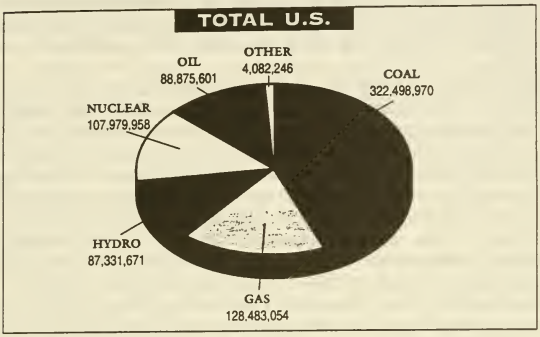
Although IOUs would argue that deferred taxes are paid, this is true only in a nominal sense. Deferred taxes do eventually come due, but they are typically more than offset by new, higher deferred taxes. To see this one need only examine the annual balance sheets of IOUs. If these taxes were being paid, there would be little or no accumulation in the deferred tax accounts of investor-owned systems. At the end of 1954, the first year accelerated depreciation was allowed, IOUs accumulated $134 million in deferred taxes. By the end of 1986 this deferred tax account grew to $39.6 billion—almost 300 times what it had been in 1954. ITC deferrals began in 1962 and totaled $35 million. By the end of 1986 this deferred tax account grew to $17 billion—486 times its 1962 value.

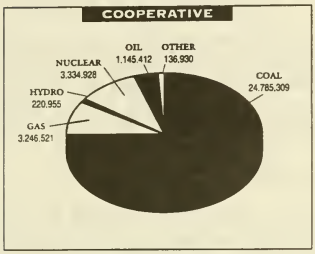
Although the estimate of the federal tax subsidy to IOUs will vary depending upon the particular assumption used, two important characteristics of the subsidy estimates do not change: (1) the magnitude—several billions of dollars per year, and (2) the significant relative impact on the revenue requirements of investor-owned systems. □

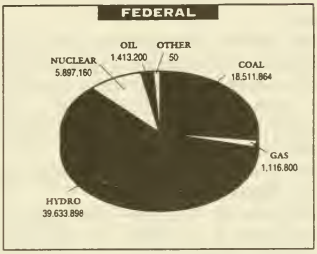
John Kelly is director of economics and research for the American Public Power Association.

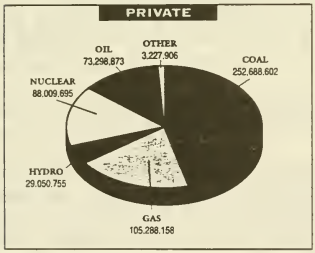
U.S. Electric Utility Generating Capacity, 1991

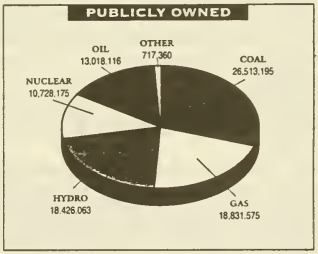
NAMEPLATE CAPACITY IN KILOWATTS. NUMBERS REFLECT JOINT OWNERSHIP AND INCLUDE PUERTO RICC











Mr. KOPETSKI. Questions from the committee.

Mr. Hoagland, any inquiry?

Mr. HOAGLAND. Yes.

Mr. Smith, I am curious as to why in seeking revenue to fund H.R. 2026, all of you in title 3 appear to be reaching into the pockets of public power, if I understand Mr. Johnson's testimony correctly. I mean, is there—is that the only way to fund it, was that the reason?

Mr. SMITH. No, is this on—I believe that is not the case at all. As indicated, I am testifying with respect to H.R. 784, that doesn't include the provisions that were discussed in respect to H.R. 2026.

As I understand it, Mr. McDermott has other revenue sources that he is recommending that deal with the issue of funding H.R. 784. I believe it is Mr. Stark's proposal to accelerate the collection of taxes on HCFCs and other ozone-depleting substances, which provides more than enough revenue to pay for the revenue estimate, which I understand is about $230 million for a 5-year period. That estimate was made by the Joint Tax Committee staff.

Mr. HOAGLAND. Does Southern California Edison endorse title 3, or can you do without title 3? I am new to that legislation and new to these issues. I don't understand why title 3 was included, I guess.

Mr. SMITH. We are not testifying on that bill. As I indicated before, I am here today representing a number of utilities, regulators and environmental groups. And while we are all united on the position with respect to H.R. 784, we are not necessarily united on all the provisions of 2026, I am not testifying on that bill here today.

Mr. HOAGLAND. OK.

Mr. PAYNE. Would the gentleman yield?

Mr. HOAGLAND. Yes.

Mr. PAYNE. During the last panel I put into the record a statement from a number of institutions, organizations including the American Public Power Association, the National Governors Association, and others, who had some concerns about H.R. 2026 as a result of the financing mechanism. I think that what was stated in that letter is very similar to what Mr. Johnson has stated in his testimony.

Mr. HOAGLAND. Are there any panelists who would feel comfortable explaining the relationship between title 3 and the rest of the bill?

Mr. MARVIN. If I could, Congressman Hoagland, I think it is important to point out for the record that while AWEA does not take a position on title 3, section 302 specifically, it is important to point out for the record that it does not raise revenue. It is revenue neutral.

Those bonds would go toward other uses, whether they be schools or other facilities. I think that the bottom line is Congressman McDermott has gone through a lengthy process in analyzing the Federal Energy Tax Code and how it relates to energy decisions in the country.

What he has done is made a determination based upon studies offered by the Alliance to Save Energy and others, that there is a fundamental inequity with respect to the demand side, and then

with respect to nonfuel—using supply sources such as wind, solar, and geothermal.

What Congressman McDermott did, in effect, is to attempt to address all of the woes that he saw in one bill. It is very clear that just one subsection of title 3, more than pays for the rest of the bill. Its goal was not necessarily to solely be self-financing. Its goal, and it is clear today that it has succeeded in that, is to ask and have answered a number of questions about fundamental issues dealing with energy policy. I think we have shown that Mr. McDermott has excelled in that particular goal.

Mr. VAUGHN. Mr. Hoagland, if I could try to address that as well. The domestic ethanol industry views this as not only a serious threat but a serious misunderstanding of the tax incentive structure that has been in place for ethanol that was recently extended by this committee; the relationship that tax incentive has to our agricultural plans, our agricultural spending.

This committee, in fact, acted to extend the tax incentive for ethanol just 2 years, on the basis of one of the most exhaustive economic, econometric models ever done by the Wharton School of Economics, that the Federal Government saves approximately $1.50 to $2 for every dollar that goes out in an ethanol incentive. This year alone, saving some $460 million.

Congressman McDermott did not talk to the domestic ethanol industry about funding his proposals for geothermal and wind and solar by taking the ethanol industry out of business. It is not only inequitable. It is wrong.

There are ways in which you can restructure the energy tax subsidies in very dramatic and very effective fashion. This would be both dramatic and both effective and unbelievably destructive to probably the most efficient use of a tax subsidy that this Congress, this committee has acted upon in making commitments and promises, not only domestically, like Blair, Neb., to build a plant, but to facilities all across the Caribbean Basin, when it was promised that the gates would be open for import to this country, that tax subsidy would be available to them to recoup their costs in building those facilities.

We would like to work with the Congressman to expand and develop those resources, but it makes absolutely no sense to tear down one renewable domestic energy resource in order to promote the development of others.

Mr. KOPETSKI. Mr. Neal may inquire.

Mr. NEAL. Thank you, Mr. Chairman.

I just want to note that I think Mr. McDermott's position is in the right direction. And his efforts particularly to encourage energy efficiency and the use of renewables are pleasing to me. I am also delighted he is a cosponsor of legislation that I have offered here to lift the cap on tax-exempt bonds.

I also, in my former life as mayor of Springfield, am a big believer of municipal financing. In many instances, that is the only way it could be done. That opportunity is not available. If that incentive is not offered, those projects never get off the ground.

By and large, I am enthusiastic about Mr. McDermott's approach with some modifications. I also want to thank him because he has agreed to work with me to hammer out a pretty good package.

Mr. KOPETSKI. Mr. Payne may inquire.

Mr. PAYNE. Thank you, Mr. Chairman.

I don't have any questions. I just wanted to reiterate a statement that I made in the last panel. I think in terms of encouraging new renewable sources of energy, I certainly applaud the concept.

However, I have some real concerns about sections 302 and 303 because of their funding provisions and because of the legislative changes they require.

I have no further questions, but I did want to reiterate my concern and to say that I put two letters into the record, one that I mentioned to my colleague, Mr. Hoagland and a second from the National Rural Electric Cooperatives' chairman, Bob Bergland, who expressed some grave concerns about the change in the tax-exempt status for electric cooperatives.

Thank you.

Mr. KOPETSKI. Mr. Smith, what role do tax considerations play in deciding whether to make conservation expenditures? How significant?

Mr. SMITH. It plays a very significant role. It can increase the cost dramatically. If you look at a comparable item, in terms of what the cost impact might be, it would be the change in law that took place several years back with respect to the contribution in aid of construction. That item used to be tax exempt for utilities and it was made taxable; that increased the cost that utilities charged customers for the contribution in aid of construction by between 25 and 30 percent. I believe that a similar percentage increase could be attributable to the increased costs that would be required for the revenue requirement for conservation expenditures, also.

Mr. KOPETSKI. One conservation approach that many companies—and I know maybe some of those in the forest products are moving maybe not fast enough because it is expensive—is cogeneration, which is an area where there was now wasted energy, if you will, that goes up in steam to build $100 million facilities on site, to capture that steam, drive turbines power the plant, and sell it to the local PUD or power grid. Because of the cost of the oil and energies today, it seems that there is a marketplace incentive to do that.

How necessary is it to add a tax credit on to provide that incentive?

Mr. SMITH. Is your question directed to conservation expenditures?

Mr. KOPETSKI. This could be viewed as a conservation expenditure; would it not?

Mr. SMITH. No. It would not be a conservation expenditure. What we refer to as conservation expenditures and what H.R. 784 addresses are expenditures incurred by utilities to provide services and products for customers to help them to conserve energy. The utility doesn't own or have any ownership interest in the expenditures we are talking about.

Mr. KOPETSKI. For that measure, we are talking about wrapping water heaters?

Mr. SMITH. Yes. Advertising to provide information to consumers on how to conserve energy, energy efficient products, subsidies for

them to purchase energy efficient refrigerators. What we call energy audits, where we send in utility employees or contract with outside agencies to come in and consult with businesses and residential customers on how they can save energy by installing energy efficient lighting and by getting rid of the old freezer in the garage that consumes large amounts of electricity and other measures.

Mr. KOPETSKI. We have already done that a lot in the Northwest. I mean, that doesn't happen in other parts of the country?

Mr. SMITH. Actually, I think in all parts of the country, even in the Northwest, and on the West Coast where our utility is located, that there is more activity taking place there than in other regions in the United States. I think even in those areas, it is generally viewed by utilities and regulators alike, that there are more opportunities for conservation and that we have just scratched the surface and there is still a tremendous potential to save energy through conservation, as well as use energy more efficiently.

Mr. KOPETSKI. We just, at least the House voted a new kind of tax, the Btu tax. Have you heard that one? Doesn't that provide the incentive for individual customers to weatherize and get into the energy conservation business in and of itself? I mean, this is a controllable tax to some extent.

Mr. SMITH. To the extent that you increase the price of energy, I would agree that it has some—that there is some elasticity in demand for electricity, that it would motivate people to conserve energy.

Mr. KOPETSKI. OK. Mr. Marvin, now, I kind of struggled, at least this country struggled with the fact that people ought to pay taxes that make money in this country. It is OK. We want them to make money and we also want them to pay taxes to help out the government a little bit and defend this country.

Mr. MARVIN. I don't like where you are going with this.

Mr. KOPETSKI. Don't you think——

Mr. NEAL. Mr. Chairman, that is a modest way of explaining it.

Mr. KOPETSKI. Well, I am not esteemed. See, if I was esteemed, I would have a better way. The Treasury Department has testified in opposition to permitting the energy credits to offset the AMT, partly on the grounds it would undermine the goal of everybody paying some taxes; how do you respond to this?

Mr. MARVIN. Well, I tried to respond to that in part of my oral statement. My written statement was submitted prior to the Treasury's position being made public.

I think the most important thing is we understand Treasury's opposition to full-scale, 100-percent exemption from the alternate minimum tax. I think it undermines the fundamental precept of the 1986 Tax Reform Act. And if this committee is going in that direction, so be it.

I suspect it will not be the American Wind Energy Association that pushes the Ways and Means Committee in one direction or the other. We have advocated partial, 25 percent, a partial relief from the alternative minimum tax to make sure that the fundamental goals of the AMT system are met, and that is that all taxpayers with economic incomes at least make a contribution. We would be more than happy if the committee were to decide that each and all of our competitors in the electricity generation field

were to pay their full AMT tax. I think it would perhaps weaken our argument somewhat.

We find ourselves chasing a rather elusive playing field. And I apologize, I swore I would not use that phrase during my testimony today, but it is a rather dynamic playing field, as we attempt to chase what clearly is the most cost-effective source of electricity generation, that being natural gas, and then we find ourselves looking uphill because of new credits given to gas. That was the goal of the Production Tax Credit, tax equity which was actually put forth as part of President Bush's Department of Energy's Natural Energy Strategy. They recommended that a two-cent per kilowatt-hour production tax credit would level that proverbial playing field.

The Ways and Means Committee decided that a 1½ cent production credit would be appropriate, and we very much appreciate that. Simultaneously, the committee granted relief from AMT for independent oil and gas producers, with respect to intangible drilling costs and depletion allowances.

We find ourselves in this inequitable position of chasing a moving target. We find ourselves in a lot of similar situations, in a sense we are very new and, thus, we cannot attract capital without some sort of an incentive. We are "risky." We are small. All of the things that traditional capital markets despise. So we find ourselves as a new technology struggling to get over that hump of not being called "risky" anymore. And one of the ways we can do that is to fully utilize the production credit, which the Ways and Means Committee offered up as part of title 19, and we are finding we simply can't use it right now.

Mr. KOPETSKI. Thank you.

Further questions, Mr. Hoagland?

Mr. HOAGLAND. Yes.

Mr. Chairman, this is obviously an exceedingly complex area. I had hoped we could set aside some time and learn more about it. These gentleman all come from organizations with very good reputations.

Southern California Edison has done some remarkable things in its geographical area to conserve and to generate power also through alternate means. Three of you have come clear across the country in order to give us your thoughts about this, and we recognize how important it is and we are going to have to do a lot of work to get up to speed.

One of the great reforms that Senator George Norris brought to Nebraska, Senator George Norris was responsible for four constitutional amendments and four major statutory schemes TVB, the Federal Reserve and he also brought public power to Nebraska, and we are all public, so that is something else that has to be fully understood, is if these provisions would somehow change the laws with respect to public power, it would be important to know why and what the basis of that is.

But anyway, I just think all of us appreciate the time and energy you have all put into your statements and the interest you are showing in this subject.

Thank you.

Mr. KOPETSKI. Further questions?

Let me just say, Mr. Hoagland, that there are parts of Oregon that didn't get electricity until the mid-1950s and later, because of REA and some of these great programs.

Mr. MARVIN. But a large portion of eastern Oregon was powered by windmills at the time.

Mr. KOPETSKI. That is right. We got a lot of wind.

I thank each member of panel. That was a very good discussion and it is going to help us make these vital decisions.

Mr. KOPETSKI. We are going to move to one of the more interesting areas of tax law, I find, and that is the estate tax issues with the next panel.

I think Mr. Payne is going to be chairing.

Mr. PAYNE [presiding]. Is Mr. Ray here?

Would you join us on this panel, since we can combine these last two panels into one.

Before I introduce this panel, with my colleagues' indulgence, I would like to make a statement concerning this panel. This is a combined panel of panels 6 and 7. Five of the six members are here regarding a proposal to exclude from the gross estate value of land subject to permanent conservation easement. Rural land in this country today, which contributes so much to both the beauty of our natural surroundings, and the quality of our environment, is being developed at a rate of about 1 million acres per year. That means that we lose about 4 square miles of rural land every day in America.

The problems of rural land conservation are acute, particularly in areas that surround metropolitan areas and certain of our national parks and wilderness areas. There are a number of ways that this could be addressed.

One is through regulation which many would find difficult and objectionable. Another is through public purchase of land which, in many cases, has worked well, but is extremely expensive. And the third, which is what the five of the six witnesses are here to talk about today, is an incentive, a new incentive to encourage the voluntary and permanent conservation of land which is now under development and pressure. The bill is the Rural Land Conservation Act of 1993, H.R. 2031, which I recently introduced with a number of my colleagues.

On our panel today, we are pleased to have Mr. Phillip Metzger, who is the senior legislative counsel in the New York State Office of Federal Affairs. This office represents Governor Cuomo and the agencies of the State of New York.

Mr. Metzger is formerly with the Interior Department. And our chairman, Mr. Rangel, expressed his regret that he could not be here to welcome you himself but he did have a conflict. He sends his regards and thanks you for being here.

We have Mr. Robert Bloch, who is from my district. Rob is a resident of Albemarle County. He is a farmer there, a farm that is 470 acres, which are owned by his grandmother. He has a beef cattle operation. He has a master's in business administration and he makes his living farming. He will face a crisis concerning estate taxes, which he will talk to us about in a few minutes.

We have Mr. Maitland Sharpe, who is the president of the Izaak Walton League. Mr. Sharpe's organization has 54,000 members na-

tionwide, and promotes means and opportunities for educating the public to conserve, maintain, protect, and restore the soil, forest, water, air, and other natural resources of the United States, and promotes the enjoyment and wholesome utilization of these resources as well.

We also have Mr. Edward Thompson, Jr., director of public policy for the American Farmland Trust. He is formerly the chief counsel for AFT. The AFT has 21,000 members nationwide and works to stop the loss of productive farmland and to promote farming practices that lead to a healthy environment. Its action-oriented program includes public education, technical assistance in policy development, and direct farmland protection projects.

And we have Mr. Robert Lange who is a farmer as well. Bob is the fellow who convinced Dick Schulze, our former colleague, no longer in Congress or a member of the Ways and Means Committee, that there was a problem and got him started on this Open Space Preservation Act. He also farms his grandmother's farm, which is located outside of Philadelphia. It now has a fair market value of over $40,000 per acre, I understand. And he fears losing his place as well, if his family has to pay estate taxes.

Now our sixth panelist is Mr. Cecil Ray, who is here representing the State Bar of Texas, the Section of Taxation, and is here to talk about a different issue and that is the treatment of retirement benefits under community property laws. All of your statements will be entered into the record.

Mr. Metzger, if you would proceed as you wish.

STATEMENT OF PHILIP C. METZGER, SENIOR LEGISLATIVE COUNSEL, NEW YORK STATE OFFICE OF FEDERAL AFFAIRS

Mr. METZGER. Thank you.

I am Philip C. Metzger, senior legislative counsel for the New York State Office of Federal Affairs. I appreciate your kind welcome and the opportunity to present New York State's views on the Rural Land Conservation Act of 1993.

New York State has been at the forefront of natural resource conservation for more than a century. Our State Constitution's Forever Wild Provision for Adirondack Park predates the Federal Wilderness Act by more than seven decades. Recently, as well, we have worked to continue this commitment by traditional protection programs, by developing innovative public-private partnerships to safeguard the natural qualities and economic vitality of working landscapes like the Hudson River Valley Greenway and by putting, since 1986 alone, over $200 million of our people's funds into buying lands for conservation. That is the per capita equivalent of the Federal Government putting nearly $2.75 billion into land acquisition.

So New Yorkers have proven we are willing to carry our share of the land conservation burden, but because we have done so, New York, like many other States, has little public money left for those purposes. We now must increasingly depend on collaboration with land trusts and both of us must increasingly rely on private landowners' commitment to conservation and their charitable instincts.

The Rural Land Conservation Act would substantially help us in this effort by clearing a wider and more expeditious path for chari-

table donations of qualified permanent conservation easements. That is a worthy objective, which New York State endorses, and we urge Congress to enact.

New York State's interest in conservation easements specifically is substantial. Our Department of Environmental Conservation has had an active program of easement acquisition focused on Adirondack Park. In a period of less than a decade, in which easements in gross could be created in New York State, that is since 1983, the total acreage of State and land trust easement holdings has reached over 125,000 acres statewide, somewhat less than three quarters of which were purchased by the State.

Land trusts total many more easements in number than the State, mostly covering agricultural properties and the scenic Hudson Valley and Eastern Long Island. Though of much less acreage than the State's purchased holdings, these land trust easements remain strategically located and help rural communities shape their own economic destinies by retaining a critical mass of operating farmland or timber land. Now that New York State has virtually no funds for easement purposes, it is even more important to provide incentives for landowners to donate permanent easements.

From the experiences of our own agencies and discussions with land trust personnel, we are confident that many more land owners in New York State would be willing to donate permanent conservation easements to governments or land trusts, if they knew that by doing so they would render the remaining interests free of estate taxes so long as the land remained in their family. The bill does assure that if an owner retains any development rights, which the IRS requires be consistent with qualifications on easements, those rights will remain subject to estate taxes but only when they are disposed of, giving the original owner the revenue with which to pay the tax.

Reasonable questions asked about this bill really boil down to a fundamental one: Will the public get a sufficient benefit to justify foregoing the revenue this legislation would cost?

We believe the answer is emphatically yes. Before donors of land interests are eligible for the estate tax exemption or deferral, they must have donated an easement which passes the extensive and rigorous scrutiny of the IRS and its lengthy and detailed regulations on qualified conservation easements. So the same guarantee of public benefit that applied to the original easement donation applies equally to this estate tax treatment.

We do appreciate the concern voiced that some owners would gain this tax benefit who don't need it. If that might be true in a few cases, that is not a reason to deny the benefit to the many who want to but cannot afford to preserve their land without it. The bottom line must be, what benefit does the public obtain from the legislation?

The fact of public benefit is assured by the IRS regulations. What this legislation would do is significantly expand the extent of that public benefit.

In conclusion, it is not an exaggeration to say that this legislation presents a historical opportunity comparable to the creation of the great national parks and forests created during the 1930s, particularly in the Eastern United States. Though that was a time of

even greater fiscal stringency for the Nation, it was also perhaps the last moment in our history when land prices made it thinkable or possible to create those vast reservations. Surely we are all grateful that the government had the courage and foresight to leave all of us this priceless legacy.

Today, New York State's Open Space Conservation plan identifies dozens of valuable properties threatened with development, which we now lack the means to protect. Most States across America face similar dilemmas. If we can't repeat the conservation achievements of the 1930s today, this legislation does offer us a chance to leave our legacy for future generations—to protect some of the open spaces and distinctive economic life of rural America while we still can.

Thank you for this opportunity.

Mr. PAYNE. Thank you very much, Mr. Metzger.

[The prepared statement follows:]

STATEMENT OF PHILIP C. METZGER
ON BEHALF OF THE STATE OF NEW YORK

I am Philip C. Metzger, Senior Legislative Counsel in the New York State Office of Federal Affairs. The Office in located here in Washington, D.C., and represents Governor Mario M. Cuomo and the agencies of the State of New York.

I appreciate the opportunity to present New York State's views on H.R. 2031, the Rural Land Conservation Act of 1993, introduced by Representative L.F. Payne of Virginia. This bill would exclude from federal estate taxation qualified land interests subject to a permanent conservation easement, and would defer eligible remaining development rights from estate taxation until those rights are disposed of to a subsequent owner.

The people of New York State have a particular interest in this legislation, because for more than a century, we've been at the forefront of natural resources conservation. Our State Constitution contains a "forever wild" provision protecting public lands in the Adirondack Park, a provision that predates the federal Wilderness Act by more than seven decades.

In recent years, we have worked to continue this commitment by protecting open space, wetlands and other sensitive habitats, and prospective wilderness and wild forest lands in the Catskills as well as the Adirondacks; and by developing innovative public-private partnerships to safeguard "working landscapes" like the Hudson River Valley Greenway, which include family farms and timberlands which remain a vital part of our State's economy.

This legislation would greatly advance the State's unabated efforts to achieve these important conservation objectives. Since 1986 alone, New York State has put over $200 million of our people's funds into acquisition of conservation lands. That's the per capita equivalent of the federal government putting nearly two and three-quarter billion dollars into land acquisition. So you can see, we in New York State have borne a sizeable share of the land conservation burden recently, as we have for many years.

But having done so, New York -- like many other states -- has little public money left for these purposes. We are increasingly dependent on our collaboration with the private, not-for-profit land conservation community -- land trusts -- which are effectively and professionally advancing this work throughout New York. And, both the State and our land trusts must increasingly rely upon the commitment to conservation and the charitable instincts of private land owners.

The Rural Land Conservation Act would eliminate the serious obstacles that current federal estate taxes place in the path of charitable donations of qualified, permanent conservation easements, and would thereby clear a much wider and more expeditious path for land protection. That's a worthy objective, which New York State endorses and we urge Congress to embrace.

New York State's interest in conservation easements is substantial. Since 1983, when we revised our state law to permit the creation and holding of easements in gross, the Department of Environmental Conservation (DEC) in particular has been closely involved in the creation, recordation and holding of easements. The relevant state statute -- Article 49, Title 3 of the Environmental Conservation law -- requires that all conservation easements, regardless of their holder, must be filed with DEC. So DEC is our clearinghouse for information about conservation easements, which our law states can only be held by State and local governments and qualified, non-profit conservation organizations with 501 (c)(3) status.

Finally, DEC itself directly acquires and holds conservation easements obtained by gift or purchase. We have had an especially active program of easement acquisition in Adirondack Park. DEC's

holdings total 106,613 acres contained in 44 easements, 9 of which were obtained by gift (16,783 acres) and 35 of which (89,830 acres) were purchased for $32,798,991. Additional easements comprising relatively small total acreage are held by the Office of Parks, Recreation and Historic Preservation, mostly in historic structures and properties.

Land trust easement holdings that have been registered total 16,902 acres in 198 easements, though not all are registered yet. Most of these land trust easements cover agricultural properties in three counties: about 4000 acres in Dutchess County and 3000 acres in Columbia County, both in the scenic Hudson Valley, and 7000 acres in Suffolk County, covering farmlands and Pine Barrens of Eastern Long Island. Another 2000 acres are in the Adirondacks.

When the State buys easements, the cash flow generated has enabled hard-pressed owners of timberland or farmland to stay in operation, sustaining the local economy, while the open space character of the land, and public access to or around it, are protected forever. Again, now that New York State has virtually no funds for easement purchases, it is even more important to provide incentives for land owners to make charitable donations of permanent easements.

This legislation would create incentives which are applicable to the situations of more and different landowners. Many owners, as other witnesses on this panel are discussing, have relatively little taxable income, and thus can't reap the full tax benefit of an easement donation. In fact, donating an easement would deprive them of the only asset they have to pay estate taxes and still enable their families to stay on the land.

From the experiences of our own agencies and discussions with land trust personnel, we are confident that many more landowners in New York State would be willing to donate permanent conservation easements to governments or land trusts if they knew that, by doing so, they would render the remaining interests free of estate taxes so long as the land remained in their family. The bill does assure that any development rights retained, which the Internal Revenue Service requires be consistent with the qualification of the easement, will remain subject to estate taxes -- but only when they are disposed of, giving the original owner the revenue with which to pay the tax.

Some who have reviewed this bill properly ask a number of questions which boil down to a fundamental one: will the public get a sufficient benefit to justify foregoing this revenue? We believe the answer is, emphatically, yes. Before owners of land interests are eligible for the estate tax exemption or deferral, they must have donated an easement which passes the extensive and rigorous scrutiny of the IRS and its lengthy and detailed regulations on qualified conservation easements. So the same guarantee of public benefit that applied to the original easement donation applies equally to this estate tax treatment.

And that analysis applies to a related question: does the deferral of estate taxes on retained development rights amount to a subsidy of holding costs for land speculation that will destroy the public benefit from the easement? The answer must be no. Under its current regulations, IRS should not approve the donation of any conservation easement which allows the donor to retain an amount of development rights which could prevent the achievement of the conservation purpose of the easement. Deferral serves the same objective for these interests that exemption does: it prevents the forced sale of a land interest which is subject to a conservation easement in order to pay the estate taxes on the interest. Moreover, it is consistent with the general principle that capital gains aren't taxed until they are realized on disposition. In the case of a cash-poor family farmer or timberland owner, disposition of the development right is the event

which assures that the seller has the resources, within the bounds of the transaction, to pay the applicable taxes.

Lastly, we understand the concern voiced that some owners would gain this tax benefit who don't need it. If that might be true in some cases, it is not unique to this issue and, most importantly, it is not a reason to deny the benefit to the many who want to but cannot afford to preserve their land without it.

The bottom line must be, what benefit does the public obtain from the legislation? The fact of public benefit is assured by the existing IRS regulatory structure. What this legislation would do is significantly expand the extent of that public benefit.

I'd like to conclude by offering a sense of historical context for the great opportunity that this legislation presents. During the 1930's, America was as hard-pressed fiscally as it's ever been. Yet we found the resources to buy millions of acres of land for national parks and forests throughout the country, and particularly in the Eastern U.S., at perhaps the last moment in our history when land prices made it thinkable or possible to do so.

Today, six decades later, we seem unable to find the resources to protect even the relatively few scraps of unprotected, truly wild land near our big cities, though our far larger population today exerts far greater recreational pressure on the lands that are protected, and though our national wealth is far greater.

Today, the one thing we can do is find the means to protect simultaneously some of the open spaces and the economic vitality of rural America. New York State's Open Space Conservation Plan contains dozens of valuable properties threatened with development, and which we now lack the means to protect. These lands, and others like them all across America, embody the very image of where we came from and who we are as a nation. Like the Shenandoahs and Great Smokies of the 1930's, or the Bear Mountains and Harriman Parks in New York State, this may be the last moment in our history when we can protect so much. New York State strongly supports enactment of this bill, because it gives you the means to leave a priceless legacy which we cannot secure in any other way, and for which future generations will be truly grateful.

STATEMENT OF ROBERT A. BLOCH, MANAGER, CLOVER HILL FARM, GORDONSVILLE, VA.

Mr. PAYNE. Mr. Bloch.

Mr. BLOCH. Thank you, Mr. Chairman.

This is an awkward moment for me because I am uncomfortable asking for favors. I believe in discovering or inventing private sector solutions to problems, if at all possible. However, after years of frustration with this government-caused problem, I feel that only government can provide remedy.

My grandfather bought Clover Hill Farm in 1946, which contains about 470 acres. At that time, it was just a farm, pretty far from the small town called Charlottesville. Its gently rolling topography and naturally fertile soils made it an ideal grazing farm, and in time, we had one of the better cattle herds in Virginia.

In those days, farmland in our area was bought and sold for its production value, much as farmland still is in most of the country. Into the early 1960s, farmers were still able to purchase land for less than $100 an acre. However, in the late 1960s, town became city and land values began to spiral upward to where now, barely two decades later, our farmland is now assessed at over $4,000 an acre.

This involuntary, speculative inflation will be our ruin. We manage Clover Hill as a working farm, not as speculative investment. My grandmother owns the farm and would love for the family to be able to continue operating after she is gone. And here is where you come in. We will likely be forced off our land solely because of Federal estate and gift taxes.

The IRS requires that in an estate be valued at highest and best use. Our assessment is based purely on other's speculations and our family cannot control that. We raise commodities. We cannot raise our prices to cover escalating land values.

Our farm assets are probably worth 80 percent of grandma's estate, which would be in the 55 percent bracket. Since about 75 percent of the farm's value is attributable to the land valuation, it is obvious that the farm will have to go to pay the taxes. Even the 2032A provision of the estate Tax Code would not provide enough relief to make enough difference to keep us in business.

My family is committed to the conservation of this land and we have carefully considered placing it under a permanent conservation easement so that it will remain a farm. However, our income is not great enough us for to obtain any meaningful income savings by making such a donation and the possibility of facing a substantial estate tax in spite of the restrictions imposed by the easement has made us shy away from taking such a step with the law as it is written now.

Believe me, we have pursued strategies, and some of them are quite costly, to try to avoid this predicament. Yet the land values are accelerating too quickly. I doubt that we can remain in business without relief such as is proposed in this bill to exempt land from the estate and gift taxes if it is subject to a permanent conservation easement.

Why should you do this and what is in it for the country?

Employment. Through good times and bad, our little place has provided a livelihood to at least three taxpaying, hard-working

families. We have also done our share of equipment and supply purchasing.

Inventory. Clover Hill will always be in the national inventory of farmland. In these times, when it is all too easy to sell out, you will know our acreage would be available to grow food. We currently raise over 50 tons of beef per year and some timber.

Wildlife. Clover Hill feeds three herds of whitetail deer, two flocks of wild turkeys, innumerable fox, rabbit, raccoon, wandering bears, and abundant birds of all types. It is also a stopover for Canada geese.

Recreation. At least 100 nonfamily individuals enjoy the recreation opportunities on our farm annually. These include hikers, mountain bicyclists, archeologists, hunters, equestrians and an occasional Cub Scout fishing picnic. Most of this would disappear were Clover Hill developed.

I manage our place to provide all the above benefits to our community while providing a livelihood for my family. This is accomplished without receiving government money and while actually paying taxes in the process.

With what the IRS would leave us, we would have to fire everybody then quit. Why should it be the tax policy of this country to ruin a sound, socially beneficial enterprise such as ours? The current Tax Code serves to rid the American economy of its productive entrepreneurs.

Mr. Chairman, we would all benefit from the pact this proposed bill could create between us. Local urban and suburban citizens would be assured of enjoying the serene benefits of nearby, protected open space, at no ongoing government cost.

This solution to my predicament would be a positive environmental benefit for your constituents and their heirs. And I don't believe you can find more responsible resource management anywhere at such a low price.

Thank you.

Mr. PAYNE. Thank you very much, Mr. Bloch.

[The prepared statement follows:]

Statement of Robert A. Bloch, a full-time family farmer
on behalf of himself

To the Subcommittee on Select Revenue Measures of
The Ways and Means Committee

June 24, 1993

Regarding: A proposal to exclude from a gross estate the value of land subject to a permanent conservation easement.

Members of the Committee:

This is an awkward moment for me. I am uncomfortable asking for favors. I believe in discovering or inventing private sector solutions to problems if at all possible. However, after years of frustration with this government-caused problem, I feel that only government can provide remedy.

My Grandfather bought Clover Hill Farm in 1946 which contains about 470 acres. At that time it was just a farm, pretty far from a small town called Charlottesville. Its gently rolling topography and naturally fertile soils made it an ideal grazing farm and in time we had one of the better cattle herds in Virginia.

In those days farmland in our area was bought and sold for its production value, much as farmland still is in most of the country. Into the early '60's farmers were still able to purchase land for less than $100 an acre. However, in the late 1960's, town became city and land values began to spiral upward to where now, barely two decades later, our farmland is now assessed at over $4,000 per acre.

This involuntary, speculative inflation is our ruin. We manage Clover Hill as a working farm--not as speculative investment. My grandmother owns the farm and would love for the family to be able to continue operating it after she's gone. Here's where you come in. We will likely be forced off our land solely because of Federal Estate and Gift Taxes.

The IRS requires that an Estate be valued at "highest and best" use. Our assessment is based purely on others' speculations and our family cannot control that. We raise commodities. We cannot raise our prices to cover escalating land values.

Our farm assets are probably worth 80% of Grandma's estate, which would be in the 55% bracket. Since about 75% of the farm's value is attributable to the land valuation it's obvious that the farm will have to go to pay the taxes. Even the 2032-A provision of the Estate Tax Code would not provide enough relief to make enough difference to keep us in business.

My family is committed to the conservation of this land and we have carefully considered placing it under a permanent conservation easement so that it will remain a farm. However, our income is not great enough for us to obtain any meaningful income tax savings by making such a donation, and the possibility of facing a substantial estate tax in spite of the restrictions imposed by the easement has made us shy away from taking such a step with the law written as it is now.

Believe me, we have pursued strategies, some quite costly, to try to avoid this predicament, yet the land values are accelerating too quickly. I doubt that we can remain in business without relief such as is proposed in this bill to exempt land from Estate and Gift taxes if it is subject to a permanent Conservation Easement.

Why should you do this and what's in it for the Country?

1. EMPLOYMENT: Through good times and bad our little place has provided a livelihood to at least 3 taxpaying, hard-working families. We have also done our share of equipment and supply purchasing.

2. INVENTORY: Clover Hill would always be in the national inventory of farmland. In these times when it's all too easy to sell out you will know that our acreage would be available to grow food. We currently raise over 50 tons of beef per year, and some timber.

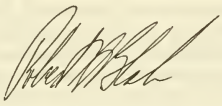
3. WILDLIFE: Clover Hill feeds 3 herds of whitetail deer, 2 flocks of wild turkeys, innumerable fox, rabbit, raccoon, wandering bears, etc. and abundant birds of all types. It is also a stopover for Canada geese.

4. RECREATION: At least 100 non-family individuals enjoy the recreation opportunities on our farm annually. These include hikers, mountain bicyclists, archaeologists, hunters, equestrians, and the occasional Cub Scout fishing picnic. Most of this would disappear were Clover Hill developed.

I manage our place to provide all the above benefits to our community while providing a livelihood for my family. This is accomplished without receiving government money, and while actually paying taxes in the process.

With what the IRS would leave us, we would have to fire everybody then quit. Why should it be the tax policy of this country to ruin a sound, socially beneficial enterprise such as ours? The current tax code serves to rid the American economy of its productive entrepreneurs.

Ladies and Gentlemen, we would all benefit from the pact this proposed bill could create between us. Local urban and suburban citizens would be assured of enjoying the serene benefits of nearby, protected open space at no on-going government cost. This solution to my predicament would be a positive environmental benefit for your constituents and their heirs. And I don't believe you can find more responsible resource management anywhere for such a low price.



STATEMENT OF MAITLAND SHARPE, EXECUTIVE DIRECTOR, IZAAK WALTON LEAGUE OF AMERICA

Mr. PAYNE. Mr. Sharpe.

Mr. SHARPE. Thank you, Mr. Chairman.

My name is Maitland Sharpe. I am the executive director of the Izaak Walton League of America. It is a great pleasure to be here today and have this opportunity to testify on behalf of the members of the league.

The Izaak Walton League of America strongly supports your bill H.R. 2031, the proposed Rural Land Conservation Act. The league is a 50,000-member conservation organization built primarily of local chapters located in towns, rural areas, and small cities scattered throughout America.

All too often lacking access to public lands and waters, league members hunt, fish, hike and picnic and otherwise enjoy recreational activities frequently on the privately owned farms and forests surrounding those towns and cities. Our members from across the country report that favorite fishing and hunting areas are disappearing at increasing rates as America's farms and woodlands are converted to various forms of urban sprawl and development.

Many members of the league live in rural America. Some are farmers. Many come from farm families. Our members were thus sympathetic with the plight of the many family farmers who are all too likely to find that estate tax liabilities force them to sell or subdivide the family farm in order to meet their Federal tax burdens.

This proposal as you noted, Mr. Chairman, was initially framed to help address the dilemma that the Federal estate tax proposes to these land-poor farm families. We believe this bill although narrowed in geographic scope will provide significant benefits to families across the country who want to keep their lands and their families in farming activities across the generations.

By helping to keep lands in working farms and resisting the pressure for subdivision, this bill would help maintain the economic and social fabric of rural life, and at the same time, benefiting many of our members. It would provide widespread public benefits in the form of open space and improved wildlife and fisheries habitat.

The members of the Izaak Walton League are by and large not people of means. They are not wealthy by any stretch of the imagination. Like other Americans of modest means, they are sensitive to measures that channel disproportionate benefits to the wealthy, but, in our view, this bill does not raise that specter. It does not properly suffer from that objection. This is not a rich man's bill.

Mr. Chairman, you, as I understand it, have made it quite clear that your proposal is to meet the costs of this measure by making a slight increase in the top marginal rate of the estate tax. It is true that some of those donating conservation easements under this bill will be wealthy and some of the financial benefits will flow—will thus flow to the wealthy, but all of the costs will be covered by the wealthy. Thus, this objection, too, seems to be without merit.

Since the league was formed in the early 1920s, my organization has worked hard to preserve and protect America's outdoor resources. We promoted the establishment of public parks, recreation areas, wildlife refuges, wilderness areas.

The league was the original proponent and one of the most active supporters of the Land and Water Conservation Fund which has channeled billions of dollars into the protection of the public land recreation resources.

But now in the 1990s, we find that every day brings new evidence that public acquisition efforts are falling behind the need. And given the Nation's current budget problems, we see very little hope that this situation is going to be reversed in the foreseeable future.

H.R. 2031, in our view, offers, as Mr. Metzger noted, an historic opportunity, an opportunity for an innovative and long-overdue alternative to public expenditures for the protection of important natural resource lands. It opens a new door to public-private cooperation. It would provide for the first time a tax incentive for natural resource protection designed to appeal to people of modest incomes.

Thus, we certainly urge this subcommittee to act favorably on your bill, Mr. Chairman, H.R. 2031.

Thank you. Thank you for the opportunity to testify.

Mr. PAYNE. Thank you very much, Mr. Sharpe.

[The prepared statement follows:]

Statement of Maitland Sharpe, Executive Director,
Izaak Walton League of America
to the
Select Revenue Measures Subcommittee of the
Ways and Means Committee
June 24, 1993

The Izaak Walton League of America strongly supports H.R. 2031, the proposed "Rural Land Conservation Act of 1993." The League is a nationwide, 50,000-member conservation organization built primarily of local chapters located in towns and small cities scattered throughout rural America.

All too often lacking access to public lands and waters, League members fish and hunt and enjoy other recreational activities on the privately-owned farms and forests surrounding those towns and cities. Our members across the nation report with anguish that favorite fishing and hunting areas are disappearing at increasing rates as America's farms and woodlots are converted to various forms of urban sprawl.

Since 1922, the Izaak Walton League has worked diligently to preserve and protect America's outdoor resources. We have promoted the establishment of public parks and recreation areas at local, state, and national levels. The League was one of the earliest and most active proponents of the Land and Water Conservation Fund.

Now, in the 1990's, every day brings new evidence that public acquisition efforts are falling ever behind the need. And given the Nation's budget problems, we see little hope for improvement.

H.R. 2031, in our view, offers an innovative and long-overdue alternative to public expenditures for the protection of important natural resource lands. It would open a new door to public/private cooperation. It would provide--for the first time--a tax incentive for natural resource protection designed to appeal to people of modest incomes.

The Izaak Walton League is dismayed that the Clinton Administration has decided to oppose enactment of H.R. 2031. This decision is another example of failure to deliver on campaign oratory about environmental conservation. Enactment of H.R. 2031 would be true "change." Instead, the Administration offers us the status quo.

We urge this Subcommittee to act favorably on H.R. 2031.

National Office: 1401 Wilson Boulevard Level B Arlington, Virginia 22209-2318 Phone (703) 528-1818
Midwest Office: 5701 Normandale Road Suite 210 Minneapolis, Minnesota 55424 Phone (612) 922-1608

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STATEMENT OF EDWARD THOMPSON, JR., DIRECTOR OF PUBLIC POLICY, AMERICAN FARMLAND TRUST

Mr. PAYNE. Mr. Thompson.

Mr. THOMPSON. Thank you, Mr. Chairman.

On behalf of the American Farmland Trust, the Nation's leading advocate of farmland protection, we appreciate this opportunity to be here on this important matter. AFT supports H.R. 2031 because we believe America does need more incentives to enable landowners to protect our Nation's strategic farmland.

It is not a well-known fact, but 56 percent of all the U.S. agricultural production comes from counties that are within commuting distance of cities, a majority that includes about 87 percent of all the fresh fruits and vegetables. Much of the land located near our cities is the very best that America has.

It is prime and unique land, where the cities started as farm market centers. These lands contribute about $75 billion worth of agricultural production to this country every year and it is in this area where conflicts between agricultural and suburban sprawl are growing rampant, not only forcing farmers out of business but also consuming this irreplaceable resource.

Part of the problem, in our view, is the tax system and in particular the estate taxes which are indeed forcing farmers of all types out of business, having to sell their land for development that creates more sprawl, putting pressure on additional farmers.

I have been advising farm families for AFT for quite a few years now, about how to use the estate taxes to hold on to their land, and I can tell you that the incentive in the code today is inadequate to that task in many, many critical cases.

Special use valuation, as you heard here today, applies to only a fraction, as a practical matter, of the farmland in the country today, and the conservation easement deduction that now exists is a very poor incentive to "the land-poor" farmers with very low incomes.

On the other hand, the Federal Tax Code contains trillions of dollars of incentives to development and infrastructure for development regardless of the importance of this land for food production. This contributes mightily to suburban sprawl that is putting pressure onto these folks and it contributes to the inflation of land values which is then taxed and causes a problem with the farmers we have here today.

H.R. 2031 would help level the playing field in Federal tax policy as it affects the use of farmland in this country and would give farm families a greater incentive, and more of a choice, to keep land in agricultural production for the benefit of the Nation.

I would like to mention a couple of other things, if I could. One is the revenue cost of this bill. I understand that it has been estimated at about $5 billion.

I did a little calculation based on the 500,000 acres under conservation easement that have been concluded in all of the history of conservation. If that were worth the very large sum of $2,000 an acre, the total value of all that land would only be $1 billion and even if it were all taxed at the top marginal estate tax rate, the tax cost would be only one-half of $1 billion.

Now, we expect this bill to provide a boost for conservation easements. But we don't think it is sufficient to result in a tenfold increase within 5 years the acreage that has been put under easement in all of history. We would urge that the $5 billion estimate be reexamined because we feel it is far too high. And, as I said, the public benefit of this would be really tremendous.

The final thing I would like to comment on is section 5 of the bill which attempts to remedy a couple of IRS rulings that, in my view, have had an absolutely disastrous effect on families trying to keep hold of their land and preserve it for future generations. And we would urge your consideration of this, which would have virtually no revenue cost, regardless of what happens to the rest of the bill.

Thank you again for this chance to testify. I will be happy to answer any questions you have.

Mr. PAYNE. Thank you very much, Mr. Thompson.

[The prepared statement and an attachment follow:]

Testimony of Edward Thompson, Jr.
Director of Public Policy
American Farmland Trust
on the
Rural Land Conservation Act (H.R. 2031)
Before the Subcommittee on Select Revenue Matters
Ways and Means Committee
U.S. House of Representatives
June 23, 1993

Mr. Chairman and members of the Subcommittee, I am Edward Thompson, Jr., Director of Public Policy for the American Farmland Trust. I am an attorney with about 20 years of experience in land conservation. I thank you on behalf of AFT for the opportunity to testify on H.R. 2031.

AFT is a national, nonprofit, membership organization working to keep the nation's best farmland in agriculture. We support the Rural Land Conservation Act because it would help achieve that end at reasonable public cost.

The need to protect America's farmland has never been greater. USDA estimates that 2 million acres of farmland are lost each year to urbanization. (USDA, Second Resource Appraisal, 1987, at 3-11) This wouldn't be a problem except that much of it is the wrong land -- "prime" farmland that by definition produces the highest crop yields with the lowest production costs and fewest environmental impacts. This land, along with so-called "unique" farmlands which are the only domestic source of fruits and vegetables, is located disproportionately near our cities, many of which started as farm market centers.

A nearly-completed AFT study shows that 56 percent of all U.S. agricultural production -- and 86 percent of fruit and vegetables -- comes from urban-influenced counties. (American Farmland Trust, "Farming on the Edge," based on U.S. Census of Agriculture, 1987) This distinct and important part of our agricultural system is being debilitated by haphazard, inefficient development -- known as "urban sprawl" -- that not only consumes the best farmland, but also sets the stage for conflicts between agriculture and urban land uses.

In northeastern Illinois, for example, while population grew 4 percent during the 1980's, the built-up area grew 46 percent. [Northeast Illinois Planning Commission, 1992] Meanwhile, a scientific survey of farmers in that area by Northern Illinois University Professor Dick Esseks found that 40 percent of them have suffered economic losses due to conflicts like tampering with farm equipment, livestock predation, and excessive regulations on normal farming practices due to the proximity of subdivisions. (Esseks, 1983)

The federal tax code has a powerful influence on the use of farmland. Despite reforms first adopted in 1976, federal estate taxes are still forcing farm families to sell land for development that often ends up as "sprawl." Conservation organizations have been trying to help farmers cope, using existing estate planning techniques ("Estate Tax Squeeze," American Farmland, Summer 1992, at 8; S. Small, Preserving Family Lands) but in many cases it is not enough.

For example, the rules for §2032A special use valuation of agricultural land are so strict that only a fraction of farmers qualify. (E. Thompson, "Conservation Easements: Preserving American Farmland," Probate & Property, November-December 1992, at 12.) And the currently available deduction for conservation easements also falls short. It simply does not offer enough relief to save some of the nation's most strategic farmland, for example, the unique fruit and vegetable lands in California and Florida, in Massachusetts' Pioneer Valley, Oregon's Willamette and Washington's Puget Sound area. The same is true for scenic landscapes and wildlife habitat adjacent to national parks and refuges that have increasingly become magnets for retirement and second home development. These lands are under tremendous development pressure and their value has been greatly inflated. While this may be fine for those who want to sell out, it is disastrous for those who want to keep the land in agriculture for the long-term benefit of the nation. And, of course, that

is a result we want to promote, at least for those farmlands that are critical to U.S. agricultural capacity.

The problem facing farm families who want to protect the land is exacerbated by the billions -- probably trillions -- of dollars in federal tax subsidies that go to urban development and its infrastructure. These inducements are made available regardless of the worth of the land for food production, and are capitalized into land values, so that estate taxes practically compel the development of that land. What is worse, the low density, inefficient development promoted by these unqualified subsidies, tends to increase the local property tax burden as well. Because "sprawl" costs more to service than compact, orderly urban growth.

This whole area of tax policy needs re-examination. But meanwhile, H.R. 2031 would begin to level the playing field. The relief offered by this bill is appropriately qualified to assure that its public benefit justifies the tax cost. Land not subject to significant development pressure is excluded, as are retained development rights. And the conservation purposes test of §170, relating to qualified easements, further narrows its scope to the most critical resource lands and assures consistency with local land use prerogatives.

The revenue cost estimate for this bill, which I understand to be $5 billion over 5 years, is surprising high. There are only about 500 thousand acres now under private easements across the U.S. If this were worth an average of $2,000 per acre restricted to farming -- and that's almost certainly high when you average large acreages of low Western values into it -- the total value of the land would come to only $1 billion. Even if this were all taxed at the highest estate rate, and it wouldn't be, the total revenue cost of all conservation easements to date would only be around $500 million. So the cost estimate would have to reflect anticipated easement donations in a five-year period amounting to 10 times as much acreage as has been done in history to this point. We would expect H.R. 2031 to give a boost to conservation easements, but not <u>that</u> big a boost. With all due respect, the revenue estimate needs to be re-examined.

Sections 5 of the bill is especially important, regardless of what is done with the rest of its provisions. This section would reverse a couple IRS rulings that set saving family farms and conserving prime lands at odds in a way that Congress surely did not intend. What these rulings do is prevent a family from donating or selling a conservation easement to protect farmland, if the land is subject to §2032A special use valuation, by treating the easement as a "disposition" of property that triggers estate tax recapture. (PLRs 8731001, 8940011) This result is inconsistent with other IRS rulings that, in the context of special use valuation, approve of the transfer of easements for pipelines, subsurface mining and soil conservation purposes under USDA's Conservation Reserve Program. (PLR 9035007, Rev. Rul. 88-78, PLR 8729037) It inhibits the protection of strategic farmland at that critical point in time when it has changed hands and the new owners are deciding its future. And it is grossly unfair to those families who want to protect their land for all future generations, but couldn't pass it to the present generation without availing themselves of special use valuation -- results which are entirely consistent with each other. Whatever you do, please don't take a pass on this needed reform.

In conclusion, AFT supports passage of H.R. 2031 as a much-needed measure to help bring balance to the tax code's treatment of farmland, enabling farm families to protect strategic American food-producing resources in the face of tremendous development pressure that too often leads to costly, inefficient urban sprawl.

Thank you for your interest and attention. I will be happy to try to answer your questions.

Conservation Easements: Preserving American Farmland

By Edward Thompson Jr.

Rural landowners, regardless of whether they are commercial farmers, often are faced with significant estate tax burdens. Inflation has increased the value of rural land near cities and resorts beyond the point where many estates can afford to pay the tax without selling all or part of the farm or going even more deeply into debt. This has contributed to the annual loss of a million or more acres of American farmland, much of it on the metropolitan fringe where nearly 30% of all domestic farm production now occurs. This decline in farmland also diminishes scenic open space and wildlife habitat—both increasingly valuable to society—in areas where they are most critically needed.

Although this pressure on agricultural resources is an impending problem for national policymakers, it is of more immediate concern to those landowners and their families who do not want to sell their farms. Traditional estate planning techniques can help ease the tax burden on "land poor" farm families. But even techniques specifically aimed at keeping farms in the family, such as "special use" valuation of farmland, have limitations that often frustrate their intended purpose. See 26 U.S.C. § 2032A. For this reason, professional advisors and landowners have become increasingly interested in "conservation easements" as an innovative planning tool for farm estates.

Conservation Easements Defined

Conservation easements are restrictive covenants or servitudes running with the land that limit development and other uses of the subject property that would be in consistent with protecting its agricultural capacity, open character, scenic or natural features. Conservation easements typically are created by a landowner granting a deed to a government agency or nonprofit conservation organization like the American Farmland Trust. The grantee assumes responsibility for enforcing the restrictions for the duration of the easement, which may be a term of years or in perpetuity. Only perpetual easements may qualify for federal income tax benefits and, arguably, estate tax reductions.

The specific limitations imposed by easements can and should be adapted to the characteristics of the land and the conservation purposes to be served. For example, an easement designed to keep the land open for agricultural production should not allow residential or commercial development to cover prime soils, break up large fields or otherwise interfere with the use of modern farm equipment or agrichemicals. Easements that are aimed at preserving scenic vistas or fragile wildlife habitat usually impose stricter limits on buildings as well as on agricultural operations. All rights not specifically relinquished are retained by the landowners, including the right of quiet enjoyment (public access need not be permitted) and the right to sell, bequeath or otherwise transfer the land.

Federal Tax Policy

Federal tax policy favors the granting of qualifying conservation easements by permitting the value of property interest thus transferred to be deducted as a charitable contribution for both income and estate and gift tax purposes. 26 U.S.C. §§ 170(h) and 2055(a). The basic qualification for easements that protect open space for agricultural use is that they "serve a clearly delineated governmental conservation policy and yield a significant public benefit." 26 U.S.C. § 170(h)(4)(A)(iii); Treas. Reg. § 1.170A-14. Many jurisdictions have adopted policies to protect farmland from inappropriate development. American Farmland Trust, *American Farmland*, Summer 1991, at 8.

The value of conservation easements—and thus the amount of the permitted income tax deduction—is determined by appraisal of the land before and after restrictions are imposed. Because the value of the property attributable to a conservation easement can be excluded from the taxable estate of the grantor or the grantor's successors, conservation easements can be an important estate planning tool.

"Federal tax policy favors the granting of qualifying conservation easements by permitting the value of property interest thus transferred to be deducted as a charitable contribution for both income and estate and gift tax purposes."

Special Use Limitations

Since 1976, federal tax law has promoted the survival of family farms by permitting farmland to be "specially valued" at its generally lower agricultural resource value rather than for its "highest and best use" in qualifying estates. But the evolution of farming during the past 15 years has confined the us efulness of special use valuation as a planning tool for avoiding the breakup or sale of farms out of agricultural use.

For example, to qualify for special use valuation, the law requires that farmland not be cash rented to other farmers, even though 42% of American farmland is now leased. Similarly, farm assets must comprise at least half of an estate to qualify for special use valuation, although the land thus disqualified may be a vital part of the farming operation of family farm tenants. The maximum amount by which a farm estate may be reduced by special use valuation has been $750,000 since 1973, even though inflation has caused the value of many farms to escalate well beyond this figure. The ceiling would now be $1.035 million if indexed for inflation. To take advantage of special use valuation, heirs must continue the family farming operation and may not sell the land for 10 years under penalty of tax recapture, even though the land may be sold to another farm family. And special use valuation does not apply to federal gift taxation at all.

The Conservation Alternative

Many limitations of special use valuation can be overcome through the use of a conservation easement created by inter vivos gift or bequest. An easement can reduce the value of farmland in a decedent's estate without any dollar limitation, regardless of whether the land is leased to another farm operator or whether the decedent had nonfarm assets. In contrast to special use valuation, continued family participation in agriculture is not required, nor will subsequent sale of the land result in a recapture. Only those with a present interest in the land (including secured creditors) must consent to the granting of a conservation easement, while all heirs who inherit an interest in the land must agree to special use election. All of these advantages of conservation easements make them an attractive estate planning alternative. Easements do result in perpetual restrictions on land use. But most easements contain a "safety valve" clause permitting their extinguishment if surrounding conditions so change that their conservation purpose can no longer be achieved. Consistent with the spirit of the perpetuity requirement, IRS rules require that a percentage of any subsequent sales proceeds, equivalent to the easement value, must go to the grantee to be applied to similar conservation purposes.

Conservation easements are an even more attractive estate planning alternative when landowners can receive cash payments in exchange for granting them. More than a dozen states (Maine, New Hampshire, Vermont, Massachusetts, Rhode Island, Connecticut, New Jersey, Pennsylvania, Maryland, Delaware, Wisconsin, North Carolina and California) have so-called "purchase of development rights" or PDR programs that offer this option to qualified farmers. Qualifications usually focus on the quality of the soil and the likelihood of development. Because of the recession, funding for easement purchases has become tight in some states, so competition among landowners can be keen. The terms of government-purchased easements are less negotiable than those donated to private organizations, but their restrictions on land use are generally limited to keeping the land open, rather than telling people how to farm.

The sale of a conservation easement is yet another source of liquidity that can be used for a wide variety of estate planning and settlement purposes, including the purchase of life insurance and the payment of taxes. One common use of PDR proceeds in farm estate planning is to provide for children or other heirs who will not inherit the farm itself. This avoids having to split farm property into smaller parcels that individually would be uneconomical to farm and difficult to keep together under multiple ownership. Another potential option just opened up by the IRS (PLR 92150049, April 10, 1992) would be to arrange a like-kind

exchange of a conservation easement for other investment property that would then acquire a stepped-up basis in the estate. Ordinarily, the sale of development rights results in capital gain after a reduction in the basis of the subject property.

Special Use and Easements Together?

Special use valuation and conservation easements have similar and complementary public purposes. There is no inconsistency between preventing the breakup of family farms and preserving farmland for perpetual agricultural use. It would appear that where estate planning would achieve both purposes, a farm family should be able to take advantage of the tax incentives associated with each. This is at best only partially true.

In two recent rulings, the IRS as a practical matter has foreclosed the possibility of donating or selling a conservation easement during the 10 year period after special use valuation has been elected. (PLRs 8731001 and 8940011). Both easement transactions had been deemed a "disposition" of an interest in farm property that triggers a recapture of estate taxes abated under § 2032A. This result is inconsistent with other IRS rulings on the transfer of similar interests in land such as a pipeline easement (PLR 9035007), subsurface mineral rights (Rev. Rul. 88-78), and the right to plant certain crops on highly erosive land under the USDA Conservation Reserve Program (PLR 8729037), all of which have been deemed *not* to be § 2032A dispositions. And it tends to frustrate congressional intent in adopting § 170(h) incentives for conservation easements, while doing little or nothing to further the purpose of § 2032A special use valuation or to enhance federal revenue. Easement sales are subject to capital gains tax, which will be higher if a § 2032A election has been made because heirs do not receive a stepped-up basis in the land. 26 U.S.C. § 1014(a)(3)). A bill pending in Congress, H.R. 4201, would reverse the IRS rulings. The IRS has not ruled on whether a pre-existing conservation easement would preclude special use valuation of the subject land, though in such cases the value of the land for estate tax purposes would already have been substantially reduced, making the election less important.

Conclusion

Conservation easements can be an important estate planning tool for keeping farmland in family hands. A conservation easement is an especially attractive alternative for those who cannot qualify for special use valuation, achieving similar personal and public policy objectives. Yet, there is a clear need to reconcile the tax code provisions that respectively encourage conservation easements and favor family farms. One possible approach may be to allow a "conservation election" as an option under § 2032A. In lieu of satisfying the myriad other requirements for special use valuation —many of which are no longer closely related to the purpose of maintaining land in farming—landowners could elect to qualify by granting conservation easements that achieve this purpose. The revenue impact would be marginal because estate taxes could be reduced by a comparable amount either way. The value of farmland restricted by easement approximates its special use value in most cases. And the current confusion surrounding the relationship of the two well-intended tax incentives would be eliminated.

Edward Thompson Jr. is Vice-President for Public Policy at the American Farmland Trust in Washington, D.C.

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Anyone who has planted a garden knows how uncertain farming can be. How soon will the ground dry out so you can plant? Will there be a late frost? How much rain will we get this week? Will the crops be infested by bugs? How should you control them? What about those weeds? Come harvest, will there be enough to feed the family *and* take to market?

As if the uncertainties facing agriculture weren't enough, an increasing number of family farmers now face a new worry: Will the next generation be able to inherit the farm without a crushing estate tax burden? Can they afford to take on more debt to finance what they owe the government? What kind of pressure will that put on them to use their land's resources beyond capacity, causing soil erosion and water pollution? Will the family ultimately have to sell off all or part of its heritage—and contribute to suburban sprawl—just to satisfy Uncle Sam?

The estate tax squeeze on family farms has worsened in recent years because of the convergence of several trends. The average age of the nation's farmers is now 58 and continues to rise. Inflation has caused the value of farmland to escalate, especially near cities, where a quarter of all prime U.S. farmland is located and most of its fresh fruits and vegetables are grown. Unlike income tax rates, which declined during the past decade, federal estate taxes have remained high, starting at 37 percent and reaching 55 percent in the top bracket. Many farmers are "land poor," having little cash or other liquid assets with which to pay estate taxes and sizable debts that inhibit their ability to borrow.

The net result is that more farm families are subject to higher estate taxes but lack the means to pay them. This seems to be one factor contributing to the increasing concentration of farm ownership into fewer hands. It also may be setting the stage for an unprecedented sell-off of farms in some of the nation's most crucial food-producing areas.

Old Medicine

Since 1976, the federal tax code has provided relief for family farmers, allowing them to have their farmland assessed at its agricultural use value rather than "highest and best" development value. (Some, of course, disagree that development is the best use for fertile farmland.) This was intended to cut family farmers' tax bills and prevent forced farm sales. But the law has become antiquated as a result of a decade and a half of change in U.S. agriculture.

Due to inflation, the ceiling on estate-tax reductions is now far too low to help even moderate-size farms. Tax relief is completely unavailable to those who cash rent their land to other farmers, despite the fact that rented land now encompasses more than 40 percent of the nation's farmland.

Even worse, the law as interpreted by the Internal Revenue Service (IRS) discourages the protection of agricultural resources—a central feature of U.S. farm policy encouraged by another provision of tax law—by requiring repayment of estate taxes on "highest and best" use value if the family donates a conservation easement to prevent all future development of the land. The old medicine is no longer effective and, in the case of the IRS easement interpretation, can even be harmful to the health of American agriculture.

AFT in the Field

In recent months, AFT has begun to conduct a series of workshops on farm estate planning. Two sessions, co-sponsored by Cornell Cooperative Extension, were held in March in Columbia and Ulster counties in New York's Hudson Valley. Another was put on in May in cooperation with the Osceola Land Trust in Kissimmee, Florida, and soon there will be a workshop in Georgia. All were well-attended by local farmers, who heard not only about traditional techniques for reducing estate taxes but also about conservation-oriented alternatives like easements.

The highlight of AFT's estate planning workshop is a computer-generated comparison of the taxes before and after the application of tax-reducing techniques on typical local farms. An informational profile of local farms, including acreage, value of land and buildings, equipment, crop and livestock inventory and so forth, is obtained in advance of the workshops from local appraisers and agricultural advisers and is then fed into the computer program AFT has written expressly for this purpose. This tax comparison helps farmers in the local area understand exactly how conservation-oriented estate planning can benefit them.

On the Policy Front

AFT is also working with interested policy makers on changes in the estate tax laws to help farmers, especially those interested in conservation. For instance, Rep. Peter Kostmayer of Pennsylvania was concerned enough about the potential effects of estate tax paybacks on conservation easement donors that he asked AFT to draft legislation to reverse the IRS's interpretation of current law. H.R. 2401 would help Mary Stoltzfus *(see sidebar)* by making it clear that the donation of a conservation easement does not require farmers to pay back estate taxes foregone as a result of agricultural use assessment.

Another approach to estate tax relief for conservation-minded landowners has been taken by Rep. Richard Schulze of Pennsylvania. His bill, H.R. 2149, would exempt from federal estate taxes the entire value of almost any kind of resource land that has been put under a conservation easement—farms, forests, wetlands, wildlife habitat, open space—provided that it meets current IRS qualifications. This could be of tremendous help to family farmers and almost certainly would encourage land conservation, if the legislation's technical problems can be resolved.

Other legislators, such as Sen. David Pryor of Arkansas, are investigating the need for even broader reforms in the farm estate-tax system. Among the changes being suggested by farm organizations is increasing the amount by which agricultural-use assessment can reduce taxable estates (now $750,000) to keep up with inflation or eliminating the ceiling entirely in exchange for a longer "holding" period, such as 30 years rather than the current 10 years.

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Inflation's Impact in California

Nobody knows exactly how many farms are threatened by estate taxes, but the nation's largest agricultural state could be an indication.

In 1978, the *average* value of farms (land, buildings and equipment only—not including livestock or crops) in 18 of California's 57 counties exceeded the $600,000 maximum that individuals can pass to their heirs without taxation. By 1987, the value of the average farm had risen to that level in 28 counties.

Only two California counties in 1978 had an average farm value exceeding the $1.2 million that a farm couple can bequeath without estate tax. By 1987, five counties exceeded this maximum.

Source: USDA, 1978 and 1987 *Census of Agriculture*

1978

1987

☐ Value of average farm exceeds $1.2 million "couples" exemption

☐ Value of average farm exceeds $600,000 "individual" exemption

THE CASE OF THE LANCASTER COUNTY FARM WIDOW

Mary Stoltzfus* wanted to create a lasting memorial to her late husband Aaron* by donating a conservation easement over their farm to a Lancaster County, Pennsylvania, farmland preservation group. But the IRS had different ideas.

When Aaron died, his executor took advantage of the "special use" provision of the federal tax code, reducing the tax bill so that the farm would not have to be sold. Under the law, this resulted in an IRS lien on the property so that, if the land were sold or otherwise disposed of within 10 years, the taxes foregone could be paid back. The repayment provision is designed to ensure the land will remain in farming as the law intended.

When Stoltzfus consulted her attorney about donating the easement—which would forever prevent development of the farm—he advised her to check with the IRS because fewer than 10 years had passed since her husband's death. With assistance from the American Farmland Trust (AFT), Stoltzfus' attorney asked for a ruling that the easement donation was not a "disposition" of the property that would require the back taxes to be repaid. Because the land would remain in agriculture, AFT argued, and a separate provision of the tax code permits an income-tax deduction to encourage the donation of conservation easements, public policy would be served by ruling in Stoltzfus' favor.

"No dice," said the IRS, interpreting two sections of the tax code—both aimed at preserving family farms and farmland—to achieve exactly the opposite effect. Thus, Stoltzfus is not permitted to create a perpetual conservation legacy in memory of her late husband. At least not until she dies.

With all the difficulties and uncertainty now posed by federal estate tax law, long-term stewardship of the land takes a back seat to getting the farm, intact, into the hands of the next generation. This has prompted the American Farmland Trust to mount a campaign to educate farm families about estate planning and to promote changes in federal tax policy to help them create a conservation legacy, not just for their immediate heirs, but for all future generations of Americans.

* *Fictional names*

(continued from page 9)

AFT has suggested that an attractive alternative to making families hold onto the land for any period of time would be allowing them to make a "conservation election," putting an easement on the land to ensure it would forever remain available for agricultural use. This would be consistent with national agricultural policy, which in the past 10 years has seen a shift of payments and other incentives away from stimulating production and toward resource conservation.

As AFT President Ralph Grossi explained, "The nation's farmers are becoming better land stewards all the time. The last three Farm Bills have played a role in this, and it's time the federal tax system does so as well. Few changes would be more welcome than one that encourages conservation while preventing the breakup of family farms."

—Edward Thompson Jr. has been general counsel of the American Farmland Trust since 1981.

How Estate Planning and Conservation Easements Can Save Taxes

Typical Local Farm	Federal Estate Taxes Owed: No Estate Planning	With Estate Planning	With Estate Planning & Easement
Columbia County, NY 125 cow dairy 300 acres	$ 399,000	$ 142,200	$ 0
Osceola County, FL 2,500 acre ranch 800 head of cattle 200-acre orange grove	$1,580,900	$ 251,500	$ 0

Mr. PAYNE. We have been called to vote.

If we could take a 10-minute recess and we will resume in 10 minutes.

Thank you.

[Recess.]

Mr. PAYNE. If we could continue the hearing.

Our next witness is Mr. Bob Lange.

STATEMENT OF ROBERT T. LANGE, FARMER, MALVERN, PA.

Mr. LANGE. Thank you very much.

My name is Robert Lange, I am a full-time farmer. I have a family farm that is located outside of Malvern, Pa. It is currently owned by my grandmother who is 92 years old.

I farm strawberries, which you can see. For the last 27 days, we have been picking strawberries on 6 acres. This morning I woke up, tried to get you some to sample down here, and that is all I could find, so we picked them pretty clean. Anyway, there are some familiar faces out there, they can help themselves afterward.

Our farm is located 24 miles west of Philadelphia. A lot of advantages, a lot of disadvantages. The main disadvantage being located near an urban area is the value of land.

Currently, farmland in Pennsylvania may be worth $2,000 to $4,000. Land near urban areas can go from $20 to $40 thousand. In our case, it is $40,000 fair market value.

If you have a 200-acre farm assessed at $40,000, you have an $8 million estate. You take your deductions that you can use under current law, and that estate goes down to $6.5 million, and then we are expected to come up with 55 percent of $6.5 million.

We can't do it. We have to sell our farm. It seems to me very unfair that we are forced into this sale that otherwise would not happen. When reality hit back in 1988, I went to my Congressman, then Congressman Schulze. He came out to the farm, listened to our problem, and within a year legislation was introduced. And I recognize several faces in here that I have dealt with over the last 5 years lobbying for the bill.

I am a farmer, not a lobbyist, but I have to do two things sometimes, and the bill never got out of House Ways and Means Committee. It was voted on last year and just barely lost.

The fortunate thing was that you decided that this was a bill worthy of pursuing and have taken it on, put some modifications in it, and, hopefully, we can get this accomplished. The bottom line with this bill, it is going to preserve the integrity of your farm, the continuity of your farm, it is going to give farmers, such as myself, a piece of mind, if you will, that what I am doing and how we are keeping our farm up, we will be able to pass it down to the next generation.

There is very little incentive if I put every cent I make back into our farm knowing we are going to have to sell a large portion of it to pay estate taxes. So I am really looking for some legislation that would give me piece of mind that we can keep it, keep it in our family, keep it being productive agriculturally, and it would just be nice to see an idea transformed into legislation that would accomplish saving farmland and benefit farmers throughout the country.

I just wanted to have a very brief testimony. If you have any questions, I am willing to answer them.

This is something near and dear to me. Without this legislation—we have done everything we can under current law. We have done easements, we have paid gift taxes, getting the ground out of the estate, paying the gift tax at 28 percent as opposed to 55 percent; we have done trusts. We have done everything under the law that we can do now, and this bill is what will be the final link that we can preserve our whole farm. And this bill, I might add, is only for people that are genuinely concerned about saving their farm.

It is not for somebody that is wanting to make a quick buck or anything like that. This is something that you give up in perpetuity, that is a long time. We are willing to do that. We just want the opportunity to keep the farm and keep it in the family and keep my livelihood going.

Thank you.

Mr. PAYNE. Thank you very much, Mr. Lange.

Those are some very good looking strawberries there.

[The prepared statement follows:]

My name is Robert Lange. I am a full-time farmer. I have been farming our family farm since 1985. Our farm is located 24 miles west of Philadelphia. Currently, my Grandmother is the owner of Willisbrook Farm which has been in our family since 1896.

The farm's proximity to Philadelphia has advantages and disadvantages. The major disadvantage is that farmland near urban areas appreciates greatly in value. Typical farmland values range from $2,000.00 per acre to $4,000.00 per acre. However farmland located near urban areas might have a real estate value or fair market value of $20,000.00 to $40,000.00 per acre. When the owner of the farm dies, the Federal Estate Tax is based on the "fair market" value of the farm and not the farm value. This poses huge problems to farm families for the transfer of the farm to the next generation who want to continue to use the farm for agricultural purposes. It is such a problem, typically that the family ends up selling off large portions of their farm just to pay off the Federal Estate Tax.

There is something very wrong when the Federal Estate Tax forces a farm family to sell off its farmland just to satisfy that tax. It is a forced sale that would not happen otherwise to families that want to continue to use the land for agricultural purposes.

This problem was brought to former Congressman Richard Schulze and he introduced legislation addressing this inequity. Mr. Schulze visited our farm in 1988. He listened to our problem and introduced the legislation to alleviate the forced sale of farmland. The legislation never got passed the House Ways and Means Committee.

Fortunately, Congressman Payne saw the need to re-introduce this bill with modifications so that family farms could survive the excessive Estate Taxes. This bill would provide another choice for estate tax planning which currently has limited options. It would help the farm families who want to preserve their farmland. Congressman Payne's bill - **HR-2031 The Rural Land Conservation Act of 1993** would save untold acres of farmland from forced sale just to satisfy the Federal Estate Tax.

This bill would preserve the integrity and continuity of family farm operations throughout the United States. It would give peace of mind to farmers such as myself, knowing our heritage could be preserved and passed down to the next generation. Finally, it would be gratifying to see an idea transformed into legislation that could accomplish the goal of preserving farmland.

Robert T. Lange
Willisbrook Farm
Malvern, Pennsylvania 19355

STATEMENT OF CECIL A. RAY, JR., STATE BAR OF TEXAS, SECTION OF TAXATION

Mr. PAYNE. Mr. Ray.

Mr. RAY. Yes, sir, my name is Cecil Ray, I am from Dallas, Tex. I have practiced law there since 1961.

My practice has been concentrated in employee benefit plans, estate planning, estate and gift taxes and the like.

This statement addresses employee retirement plan issues. It is in support of some technical corrections to the estate and gift tax laws, and transfer tax laws as well. These corrections are needed by our community property residents, both taxpayers and their advisers, so that we can know the consequences of acts taken by taxpayers in this estate planning setting.

In the 1980s, substantial amendments were made to the Internal Revenue Code related to transfer taxes. We had an unlimited marital deduction, we had generation skipping transfer, et cetera, and on and on. There were certain exclusions in the estate gift tax rules that were repealed in 1984 and 1986.

The purpose of their repeal was to treat qualified employee plans and nonqualified employee plans the same equally for estate and gift tax purposes. It was intended, according to the committee reports, that the 1986 Act would have an addition to the unlimited marital deduction that would prevent current taxation on transfers between spouses of interest in their plans.

The repeal provisions of the estate and gift tax laws had accomplished equality for qualified and nonqualified plans and the participants. Some effort was made to implement this goal, a section 2056(b)(7)(C) was added to the code, but more technical corrections are needed, we think, to complete the task that was begun.

Until the marital deduction is made clearly available and other technical corrections are added to the code, the residents of the States that have for years been a part of the community property system are not being given the same and equal treatment as residents of other States. The unequal treatment results because transfer taxation of a community property interest in a plan is uncertain since the repeal of these exclusions.

It is not fair and equal to allow a possible transfer tax to be imposed on the community property residents because of certain events. These events, such as the death of a nonparticipant spouse, are not events that enable the plan to pay out money which is being taxed.

This doesn't occur in other States. It only occurs in a community property State, unless we have a marital deduction clearly in place.

Several technical corrections are needed. It should be made clear, for example, that there is no transfer tax consequence when a nonparticipant spouse consents to certain employee actions under a retirement plan, such as his waiver of a spousal annuity for her benefit where he receives a larger retirement income. That shouldn't be a tax event, but it could be under the way the present rules work.

It should be clear that no estate tax is imposed when a nonparticipant spouse dies before the surviving spouse—who is an employee and a participant—retires. Her death, long before he retires and before the plan pays out money, should not subject her

estate or his estate—for example, the nonparticipant spouse could be a he or a she—to a tax at that time.

My written statement contains several proposed amendments that address these issues as technical corrections and simplification. It is believed that there is no revenue loss in any of these amendments, since everyone I discussed this with thinks that this is the way a law ought to work anyway. But we are just not sure that it does work this way, and we need certainty in an estate planning situation.

In my remaining moments, I want to explain how some of these technical corrections will work in a general way. It is difficult for community property lawyers to fully advise their clients in an area of tax law where we are not certain of the rules. But it is important to understand that in a community property State, unlike other States, the interest that a spouse has in the plan accruing during marriage is property. In other States and in community property State, as well, the Retirement Equity Act imposed spousal annuity protection, but that is over and above, it overlays the community property system, and so until we understand that there is a distinct property interest, we don't appreciate quite as well how there could be a transfer of that property interest when certain events occur that don't occur in another State.

I hope that—and I know that the Section of Taxation of the State Bar of Texas, and I am sure similar organizations of the State of California and the other community property States, would be delighted to have the opportunity to work with the committee, the staff, in working out some technical corrections which we think would simplify the law and make our life and everyone's life a little easier.

Thank you, sir.

[The prepared statement follows:]

Cecil A. Ray, Jr.
Attorney at Law
5949 Sherry Ln,
Suite 1635
Dallas, Texas 75225-8012
214-739-1713

June 24, 1993
Hearing on Miscellaneous Revenue Issues
Subcommittee on Select Revenue
Measures
Committee on Ways and Means
United States House of Representatives

Proposed amendment to transfer-tax provisions of the Internal Revenue Code of 1986 relating to spousal annuities under the Retirement Equity Act and non-participant spouses in community-property states

Code Sections:		
	Gift Tax:	**§2503(f); new §2517; and new §2518(d)**
	Estate Tax:	**new §2039(c) and (d); new §2056(e); and new §2044(d)**
	Chapter XIII -generation skipping:	**new §2611(c), (d) & (e)**
	Chapter XIV:	**new §2702(e)**

* *

My name is Cecil A. Ray, Jr., of Dallas, Texas. I am an attorney; a sole practitioner. Since 1961 my practice has been concentrated in employee benefit and compensation issues and, to a lesser extent, in estate planning, trusts and estates. My testimony is in support of proposed legislation that I have drafted containing technical corrections needed by residents of community-property states with respect to employee plans and the non-participant spouse's community-property interest in such plans. The most pressing of the issues involves the need to clarify that the estate-tax marital deduction is available when the non-participant spouse predeceases the participant spouse in a community-property state, especially where such death occurs prior to the retirement of the participant spouse under the employee benefit plan. I have also prepared some proposed technical corrections to related issues which, I think do nothing more than clarify what most of us think is (or should be) the result under existing law.

The repeal of certain provisions of the Internal Revenue Code of 1986 ("Code") left open to question the proper interpretation of certain parts of the transfer-tax provisions of the Code and how they apply to the non-participant spouse in a community-property state. The absence of guidance on all of these issues make it extremely difficult to provide clients with adequate counsel and advise. The directors of the State Bar of Texas has authorized the Taxation Section of the State Bar of Texas to support these proposals, for statutory guidance. I am representing the Taxation Section in presenting this testimony.

Texas, along with California, Louisiana, New Mexico, Arizona, Nevada, Washington, and Idaho have historically been community-property states. While the community-property laws of these states differ, they have a common ancestor, which is the civil law systems of Spain and France. The English common law prevails in these eight states, as it does in the other states, but these eight states have systems of jurisprudence that reflect the community property heritage. For example, trusts are a creature of the English common law but the law of trusts has been adapted to the community-property system. Employee benefit plans qualified, under the Code have, since World War II, been required to use a trust for funding but the scope of the community-property interest of the non-participant spouse (husband or wife of the employee) in such plans has not been clearly delineated. i.e., The enactment of ERISA in 1974, with its pre-emption clause, has caused many of us to wonder if the community-property laws have been preempted insofar as they relate to employee benefit plans that are subject to ERISA. This is not an easy question. Some of the community-property states, have a public policy and statutory or constitutional prohibition against alimony. To preempt the community-property interest of the husband or wife in the employee benefit plan would result in an unintended shifting of the balance of economic wealth as between the participant spouse and non-participant spouse in these community-property states. Of course, a final answer must await some future decision of the United States Supreme Court.

My testimony addresses proposed amendments to Subtitle B of Title I of the Code that are needed to correct unequal transfer-tax treatment of certain residents of community-property states. These persons, collectively, are referred to herein as a non-participant spouse ("NPS"). A NPS is an individual whose spouse is covered by a pension, profit sharing, or similar plan which is qualified under Code §401(a), even though it is not defined, under Title I of ERISA, as an employee benefit plan, (for example, a plan that only covers self-employed individuals and their spouses). In addition, a NPS includes a person whose spouse is the individual that owns an IRA or SEP account. This statement contrasts the situation of a NPS residing in a community-property state (referred to as "a community-property NPS") with a NPS residing in a state that has not adopted the community-property system (referred to as "a common-law NPS").

The legislative proposal addresses the fact that a common-law NPS currently receives more favorable transfer-tax treatment, in certain instances, than does the community-property NPS. It also addresses problems that participants might incur when electing to waive spousal annuities mandated by the Retirement Equity Act ("REA").

CURRENT LAW AND REASONS FOR NEEDED CHANGES

The Tax Reform Act of 1986 ("TRA 86") completed a task that Congress first undertook in 1984. TRA 86 equalized the transfer taxation of qualified and non-qualified plans. To accomplish this, Congress deemed it necessary to repeal the estate-tax exclusion, formerly contained in Code §2039(c), with respect to interests in qualified plans upon the participant's death and the similar exclusion, formerly contained in Code §2039(d), excluding, on the prior death of a NPS, on the interest in the qualified plan attributable to community-property laws.

The Senate Finance Committee Report, in 1986, also indicated that the interest of any NPS was eligible for the unlimited marital deduction under a clarification made by TRA 86 to the marital deduction provisions of the Code. No such clarification was made then, or in subsequent acts, which, in all cases, would alleviate the incidence of transfer taxation upon the death of a NPS in a community-property state prior to receipt of the values on which such taxation was imposed. Consequently, while the transfer taxation of qualified and non-qualified plans was equalized, the transfer-tax treatment of a NPS in common-law and community-property jurisdictions became unequal.

The now-repealed, estate-tax exclusion for participants had been added to the Code in 1954 by §2039(c). That provision excluded the decedent's interest in a qualified plan from the estate tax. The now-repealed, estate tax exclusion for an interest in a plan attributable to community-property laws upon the prior death of a NPS (added to the Code in 1972 by P. L. 92-580) had extended the estate-tax exclusion to the community-property NPS. This estate-tax exclusion for the community interest of the NPS reversed the position of the Internal Revenue Service taken in Rev. Rul. 67-278, 1967-2 C.B. 323 and in several private letter rulings, see e.g., PLR 670131159A (January 31, 1967), 7109090110A (September 9, 1971), and 7833016 (May 16, 1978).

The Tax Reform Act of 1976 further amended the Code to add a gift tax provision, §2517(c), which has also been repealed. Code §2517(c) was necessary to reverse Rev. Rul. 75-240, 1975-1 C.B. 315. The Service had ruled that a NPS incurred a gift tax upon the death of the participant spouse when the community-property interest of a NPS in the qualified plan passed to the participant's designated beneficiary if the beneficiary was someone other than the NPS. In PLR 8334001 (May 17, 1985), the Service acknowledged that the enactment of Code §2517(c) prevented a taxable transfer by the NPS of his or her community-property interest in the plan in such a situation.

After these additions to the Code, and until the effective date of amendments made in 1984 and 1986, transfer-tax consequences were not incurred when the NPS predeceased the participant or upon the participant's irrevocable designation of a third person to receive the community-property interest of the NPS in a qualified plan. Therefore, a community-property NPS was treated equally with a common-law NPS. The Code never provided exclusions from its transfer-tax provisions to either the NPS or to the participant spouse for the interest such spouse might have in a non-qualified plan. Since a common-law NPS, did

not have a taxable property interest in either a qualified or non-qualified plan, such individuals needed no similar exclusion from transfer taxes.

Increased protection for the NPS was an objective of REA in 1984. The provisions of REA accomplished two desired aspects of this objective. First, it protected the NPS in divorce situations, particularly during the time that the other spouse is a participant in an ERISA employee pension benefit plan. It also protected the NPS at the participant's retirement or upon the participant's death prior to retirement. REA amended ERISA and the Code to accomplish these ends by mandating that the plan provide mandatory spousal annuities for the benefit of the NPS unless waived by the participant and consented to by the NPS. Committee reports accompanying REA indicated that the additional protection of mandatory spousal annuities was intended to provide greater equity for the NPS and to take into account the economic partnership comprised of the participant and NPS. An "economic partnership" sounds very much like the principles underlying the community-property system and may have led some members or staff to believe that, insofar as benefit plans were concerned, the community-property NPS and the common-law NPS would enjoy equal protection and identical tax treatment with respect to interests in ERISA plans after REA.

Although additional protection was afforded to the common-law NPS under REA's spousal annuity provisions, REA did not place a common-law NPS on parity with a community-property NPS with respect to protection of their respective interests in ERISA plans. The reason for the remaining difference results from the difference in the community-property rights of the NPS and the spousal annuity rights of a common-law NPS. A common-law NPS has never been deemed to have an interest in a qualified plan that was subject to transfer taxation upon its waiver or upon the NPS's death prior to the participant's death. In a community-property state, the NPS had an interest that attracted transfer taxation in those situations.

The REA amendments provided this new protection by requiring plans subject to Title I of ERISA or plans qualified under Code §401(a), or both, to provide (i) a spousal annuity upon the participant's retirement in an amount equal to at least 50% of the annuity for the joint lives of the spouses and (ii) a pre-retirement spousal annuity in case of the participant's death prior to retirement. Such annuities must be provided to the NPS, absent waiver by the participant in accordance with regulations and consent by the NPS to the waiver.

Such spousal annuities are not identical to the NPS's community-property interest in the plan. Absent preemption by ERISA, the NPS's community-property interest is transferrable, at least to the participant during the participant's lifetime, by the NPS at death, and is subject to the state law provisions regarding descent and distribution at the death of the NPS. ERISA's preemption provision and anti-alienation provision probably prevent the ERISA plan from honoring any such transfer prior to the participant's death or retirement. It may also prevent the transfer by the NPS of his or her community interest, whether before or after the participant's retirement, at least insofar as the plan is concerned, during joint lives of the parties or at the death of the NPS. The ERISA pre-emption and anti-alienation provisions do not clearly preclude a probate court, with jurisdiction over the NPS's estate, from requiring the participant, as opposed to the plan itself, from complying with the NPS's last will and testament or with the laws of descent and distribution, with respect to the NPS's community interest in the plan, as, if and when the participant receives a distribution of the interest in the plan nevertheless, the answers to these questions are not clear at present.

With respect to transfer taxation, the community-property NPS must find an exemption from estate taxation, gift taxation, generation skipping transfer taxation and from Chapter 14 transfers for the community-property interest in the plan. In addition, it is totally unclear as to how the separate-property or community-property interests in the plan (as defined by state law) are allocated or marshalled so as to fund the spousal annuity. In other words, to which kind of interest in the plan does such annuity attach for purposes of computing the transfer tax? The state law characterization of plan interests as community or separate property and the REA spousal annuities are not required to be co-extensive, one with the other.

For example, assume that the value of the NPS's spousal annuity is greater than the community-property interest of the NPS because the marriage occurred late in the working life of the participant. How should the community and separate property of the parties be allocated for transfer-tax purposes, in such a case, with respect to the funding of the NPS's spousal annuity?

In a common-law state, a NPS does not have a property interest in the plan under state law. Consequently, a common-law NPS is not treated as a transferror for gift-tax purposes by consenting to the participant's waiver of the spousal annuity protection. A community-property NPS's consent to a waiver of spousal annuities may be treated as a transfer of a community-property interest in the plan, now that Code §2517(c) has been repealed.

Code §2503(f), *by its precise terms*, only applies to the participant's waiver of spousal annuities. It states that the waiver is not a transfer subject to gift taxation. It does not apply to the NPS's acquisition of a spousal annuity nor to the community-property NPS's consent to the participant's waiver of such annuity. Moreover, it does not apply to the NPS's community-property interest. Consequently, the NPS's transfer of a community-property interest in the plan upon consent to a participant's waiver or upon an irrevocable election of an alternative form of payout is not addressed by Code §2503(f).

Upon the effective date of a joint and survivor annuity (either by the participant's irrevocable action or retirement without electing another form of payout), the community-property NPS should be protected from gift tax by the marital deduction provisions of Code §2523.

Upon the death of a community-property NPS, before the participant spouse, the NPS's interest in the plan is no longer exempt from transfer taxation by reason of explicit statutory exclusions because of their repeal. An attempt to utilize the marital deduction presents at least three problems.

First, existing Code §2056(c) and the regulations thereunder do not clearly describe how the deceased NPS's community-property interest in the plan passes to the surviving spouse (the participant). This is especially a problem when the NPS's death occurs prior to the participant's retirement date. The plan provisions are usually silent on this issue. Without an amendment to Code §2056, it is not clear that the participant spouse receives any interest from the NPS due to ERISA and its anti-alienation and preemption clause.

Secondly, the NPS's community interest in the plan is taxable in the NPS's estate under Code §2033, not under Code §2039(a), at least where death occurs prior to retirement of the participant. Consequently the joint ownership provisions of the regulations are not helpful. They require taxation in the prior estate by reason of Code §2039(a).

Finally, Code §2056(b)(7)(C) provides that the interest of the surviving participant spouse will be characterized as a QTIP so long as only the surviving souse has the right to receive payments before his or her death. Since the NPS's community-property interest is not includible in the NPS's estate under Code §2039(a) but under Code §2033, this section does not apply. Perhaps after retirement has begun, with the form of payment as a joint and survivor annuity, Code §2056(b)(7)(c) would protect the NPS who predeceases the participant spouse. For many a NPS, who die prior to the participant's retirement date, no deduction seems available under the marital deduction provisions.

EXPLANATION OF PROPOSED CHANGES TO LAW

Plan, as used in this description of the legislation, includes IRAs and SEPs.

PROPOSED AMENDMENT TO CODE §2056

The proposed amendment to Code §2056 and §2044 enable taxpayers to know for sure that the marital deduction is available upon the prior death of the NPS in a

community-property state. Unless the will of the NPS purports to dispose of the community-property interest in the plan by a direct reference to it, the statute deems it to pass to the surviving participant spouse under circumstances that qualify it for a QTIP marital deduction. If the surviving spouse (the participant), during his or her lifetime, disposes of the interest (such as in the case of a joint and survivor annuity with a second spouse), then the deferred estate tax is collected out of each payment made by the plan.

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Add a new subsection (e) to section 2056 to read as follows:

"(e) CERTAIN ANNUITY INTERESTS CREATED BY COMMUNITY PROPERTY LAWS.--In the case of an employee on whose behalf contributions or payments were made by his employer or former employer under a trust or plan described in subparagraph (1) or (2), or toward the purchase of a contract described in paragraph (3), or made by an individual or his employer to his individual retirement account or annuity, or simplified employee pension, as defined by the provisions of section 408, if the spouse of such employee predeceases him, then, notwithstanding the provisions of this section or of any other provision of law, the value of any interest of such spouse in such trust, plan, contract, account, or annuity shall be considered as passing from the decedent to the employee unless the will of such decedent by express reference to such trust, plan, contract, account, or annuity provides otherwise, to the extent such interest--

(i) is attributable to such contributions or payments, and,

(ii) arises solely by reason of such spouse's community property interest in such trust, plan, contract, account, or annuity under the community property laws of a State.

The interest of a decedent spouse which is described in this subsection--

(A) shall be treated as a qualifying income interest for life, and

(B) the executor shall be treated as having made an election under subsection 2056(b)(7) with respect to such interest unless the executor otherwise elects on the return of tax imposed by section 2001.

A decedent's interest in a plan, trust, or contract is entitled to the deduction provided for in this subsection if it is described below:

(1) An employee's trust (or under a contract purchased by an employee's trust) forming part of a pension, stock bonus, or profit-sharing plan which, at the

time of the decedent's separation from employment (whether by death or otherwise), or at the time of termination of the plan if earlier, met the requirements of section 401(a);

(2) A retirement annuity contract purchased by an employer (and not by an employer's trust) pursuant to a plan which at the time decedent's separation from employment (by death or otherwise), or at the time of termination of the plan if earlier, was a plan described in section 403(a); and

(3) A retirement annuity contract purchased for an employer by an employer which is an organization referred to in section 170(b)(1)(A)(ii) or (iv) or which is a religious organization (other than a trust), and which is exempt from tax under section 501(a), or which is a plan or governmental unit described in section 818(a)(6)."

PROPOSED AMENDMENT TO CODE §2044

Add a new subsection (d) to section 2044 to read as follows:

"(d) CERTAIN ANNUITY INTERESTS CREATED BY COMMUNITY PROPERTY LAWS.--This section applies to any interest in a plan, trust, or contract if a deduction was allowed with respect to the transfer to the decedent under section 2056 by reason of subsection (e) if such interest is not described below. If any person other than the decedent has a right to receive payments during the decedent's lifetime, then payments from such plan, trust, or contract shall be taxed at 20% until an amount equal to the tax postponed by such deduction is paid."

PROPOSED AMENDMENT TO CODE § 2039(d)

The proposed amendment to Code §2039(d) insures that a NPS in a community-property jurisdiction will not be deemed to have made a taxable transfer at the participant's death where the participant disposes of community interest of the NPS. This relief is only available for IRAs and SEPs, government and church plans and other plans exempt from the requirement of complying with REA's spousal annuity provisions in sections 401(a)(11) and 417. If the plan in fact requires spousal consent to a waiver of spousal annuities, the NPS has exercised sufficient control to justify a transfer-tax at the participant's death in certain instances.

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Add new subsection 2039(d) to read as follows:

"(d) DISPOSITION OF CERTAIN INTERESTS IN RETIREMENT PLANS OR ACCOUNTS--For purposes of this subtitle--

(1) GENERAL RULE--In the case of a decedent (who is or was an employee or other person who made or on whose behalf contributions or payments were made under an eligible retirement plan to which this subsection applies), a transfer of benefits attributable to such eligible retirement plan by such decedent shall not be considered as a transfer by the spouse of such decedent to the extent that the value of any interest of such spouse in such eligible retirement plan arises solely by reason of such spouse's community property interest in such eligible retirement plan under the laws of the State. A transfer of any amount of such spouse's community property interest in such eligible retirement plan by such decedent to an individual other than such spouse will, to the extent of such transfer, result in such community property interest being included in the decedent's gross estate.

(2) ELIGIBLE RETIREMENT PLANS TO WHICH THIS SUBSECTION APPLIES--This subsection shall apply to --

(A) any trust, plan, or contract which at the time of the employee's or other person's death or other termination of employment, or if earlier, at the time of termination of the plan--

(i) formed a part of a plan which met the requirements of section 401(a), or

(ii) was purchased pursuant to a plan described in section 403(a), or

(B) a retirement annuity contract purchased by an employer which is--

(i) an organization referred to in clause (ii) or (vi) of section 170(b)(1)(A), or

(ii) a religious organization (other than a trust) exempt from taxation under section 501(a), or

(iii) a plan or governmental unit described in section 818(a)(6), or

(C) an individual retirement account or individual retirement annuity or simplified employee pension described in section 408, provided that the contributions thereto are deductible under section 219 or that amounts held

therein are attributable to one or more rollover contributions from a trust, plan, or contract described in subparagraph (A) or (B).

This subsection (d)(2) shall apply only to a trust, plan, or contract that either is exempt from the provisions of sections 401(a)(11) and 417 by reason of being described in subsection 411(e) or does not in fact comply with sections 401(a)(11) and 417. Subparagraph (C) shall not apply to that portion of the value of the amount held in such an account, annuity, or simplified employee pension which bears the same ratio to the total value of such amount as the amount of the total value which is not allowable as a deduction under section 219 or as a rollover contribution described in subparagraph (C)."

PROPOSED AMENDMENT TO CODE § 2503

The proposed amendments to Code §2503(f) provides that neither the acquisition of nor consent to a waiver of a spousal annuity results in a transfer for purposes of tax under Subtitle B. The participant spouse in a common-law, as well as in a community-property, state needs transfer-tax exclusions upon the acquisition and the waiver of the spousal annuity. The acquisition of spousal annuities results in greater value being irrevocably acquired by the NPS upon payout under the plan. Waiver of the spousal annuity will result in a lesser value being paid to the participant during his or her life so that a greater value will be available for the NPS upon the participant's death. The community-property NPS needs the protection from estate and gift taxation when the NPS consents to the participant spouse's waiver of the spousal annuity. In such event, the NPS is relinquishing some spousal annuity protection and part of that protection is funded by the NPS's community-property interest in the plan. See proposed amendments to sections 2039(c), 2611(d), and 2702(e)(1), below, which make conforming changes and cross references to section 2503(f). These proposed conforming amendments provide that no transfer occurs for federal transfer-tax purposes, where the non-participant spouse acquires a REA spousal annuity, the participant spouse waives the spousal annuity or the non-participant spouse consents to the participant spouse's waiver of the spousal annuity.

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Change section 2503(f) to read as follows:

"(f) CERTAIN PENSION RIGHTS--If any spouse of a plan participant acquires, or any participant waives, before the death of such participant, any survivor benefit, or right to such benefit, under section 401(a)(11) or 417, or any non-participant spouse consents to such a participant's waiver of such benefit or right to such benefit, such waiver or consent to such waiver shall not be treated as a transfer of property by gift for purposes of this subtitle."

PROPOSED AMENDMENT TO CODE § 2518

The proposed amendment to §2518 clarifies that the disclaimer by a spouse of an interest in the plan is not a transfer for transfer-tax purposes. This approach is consistent with the one taken by section 2046. Conforming changes are proposed below to sections 2611(e) and 2702(e)(2) with respect to disclaimers.

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Add a new sub-section (d) to section 2518 to read as follows:

"(d) DISCLAIMER OF CERTAIN RETIREMENT BENEFITS--If any individual refuses in writing before or after the death of

(i) a participant covered by a plan which meets the requirements of section 401(a),

(ii) an individual that is treated as the owner of an individual retirement account described in section 408(a) or individual retirement annuity described in section 408(b), or

(iii) an individual that is covered by a simplified employee pension described in section 408(k),

to accept an interest in such plan, account, annuity or pension or any right to take from such individual's spouse any community property interest in such plan, account, annuity or pension such refusal shall be treated as a qualified disclaimer provided such written refusal complies with the requirements of paragraphs (2) and (3) of subsection (b)."

OTHER AND CONFORMING CHANGES

The proposed amendment to section 2039(c) and to section 2517 conforms the estate and gift tax provisions to these changes as does the proposed amendments to sections 2611(c) and 2702(e)(3). It was not intended to cause transfer taxation or generation skipping transfers or gifts under §2702 when a participant waives the REA spousal annuity or when the NPS in a community-property state consents to the waiver and thereby allows some part of the NPS's community interest in the plan to be paid for the benefit of the participant. These technical correction to the Code seem justified and needed to allow taxpayers and their advisors to correctly apply the provisions of the Code to proposed actions dealing with REA spousal annuities.

PROPOSED AMENDMENT TO CODE § 2039(c)

Add new subsection 2039(c) to read as follows:

"(c) CERTAIN PENSION RIGHTS--For provisions relating to the effect of certain acquisitions of, and consent to waivers of survivor benefits under sections 401(a)(11) or 417 for purposes of this chapter, see section 2503(f)."

PROPOSED AMENDMENT TO §2517

A new section 2517 is added to the Code to read as follows:

"SEC. 2517 **DISPOSITION OF CERTAIN INTERESTS IN EMPLOYEE BENEFIT PLANS AND ACCOUNTS**

For provisions relating to the effect of a disposition of a non-participant spouse's community property interest in a certain retirement plans or accounts for purposes of this chapter, see section 2039."

PROPOSED AMENDMENT TO CODE § 2611

Add new subsection 2611(c), (d), and (e) all to read as follows:

"(c) DISPOSITION OF CERTAIN INTERESTS IN EMPLOYEE BENEFIT PLANS AND ACCOUNTS--For provisions relating to the effect of a disposition of a non-participant spouse's community property interest in a certain retirement plans or accounts for purposes of this chapter, see section 2039.

(d) CERTAIN PENSION RIGHTS--For provisions relating to the effect of certain acquisitions of, and consents to waivers of survivor benefits under sections 401(a)(11) or 417 for purposes of this chapter, see section 2503(f).

(e) DISCLAIMER OF CERTAIN RETIREMENT BENEFITS--For provisions relating to the effect of a qualified disclaimer for purposes of this chapter, see section 2518."

PROPOSED AMENDMENT TO CODE § 2702

Add a new subsection (e) to section 2702 to read as follows:

"(e)(1) CERTAIN PENSION RIGHTS--For provisions relating to the effect of certain acquisitions of, and consents to waivers of survivor benefits under sections 401(a)(11) or 417 for purposes of this chapter, see section 2503(f).

(2) DISCLAIMER OF CERTAIN RETIREMENT BENEFITS--For provisions relating to the effect of a qualified disclaimer for purposes of this chapter, see section 2518.

(3) DISPOSITION OF CERTAIN INTERESTS IN EMPLOYEE BENEFIT PLANS AND ACCOUNTS--For provisions relating to the effect of a disposition of a non-participant spouse's community property interest in a certain retirement plans or accounts for purposes of this chapter, see section 2039."

IN CONCLUSION, I and members of the State Bar of Texas' Taxation Section would welcome the opportunity of working with the tax-writing staff to come up with technical corrections that will make the transfer taxation issues relating to community property interests in qualified plans more workable. Other approaches to this end may have substantial merit, but each solution should be crafted, I believe, not only to protect the revenue, but also to make the tax advisor's task understandable and to the maximum extent possible intuitive. Approaches that depend on the preemption by ERISA of community property should be avoided as should approaches that conflict with state laws related to dispositions of property at death.

Mr. PAYNE. Thank you, Mr. Ray.

Is it possible to devise a solution to the problems you have described in community property States with a single set of rules or will it be necessary to have some sort of exceptions that will accommodate each State?

Mr. RAY. No, I think one set of rules should cover everything.

Mr. Brennan, who is not here, I know he has worked on an approach to this but it is very similar to what I have proposed, and I think one set of rules which would be some slight amendments to the law that would cover both community property residents and others will work. It will work for both—the other States and the eight States or the more than eight States now that have community property.

Mr. PAYNE. I just have one question for any of the other panelists, and it has to do with the Treasury Department. They were here earlier this week and testified that they were opposed to H.R. 2031 because they contend that this proposal would invite abuse and that the current law, the deduction under current law for the donation of charitable easements is a sufficient incentive to have people make those decisions.

I would invite any or all of you to comment on the Treasury's position.

Mr. Metzger.

Mr. METZGER. Well, as far as the potential for abuse, really the principal safeguards against that are in the Internal Revenue Service's own hands now and their implementation of the regulations governing the original donation deduction, in that they have to make extensive determinations of public benefit and valuation, and so forth, and to the extent there are any problems, that is the point at which they would be unearthed.

In other words, this is really an accent, simply a continuation of the initial transaction in which the extent and substance of the public benefit are determined, and as to the need for any additional incentives to donate, certainly the gentlemen who testified here from their own personal experiences on the farmlands are ample witness to the inadequacy of the present incentives.

Mr. PAYNE. So you are saying the law as it exists already prohibits the abuse that the Treasury is concerned about?

Mr. METZGER. They have—they certainly should be, it certainly should be in the regulations, and if they see in its extension to this provision any further potential for abuse, they can certainly have modification of the regulations to cover that. I don't really see where that would come from, given the very rigorous scrutiny that these transactions already undergo.

Mr. PAYNE. Mr. Sharpe, did you have a comment?

Mr. SHARPE. Yes, I agree with that answer. It makes me wonder how close and careful a look the Treasury has taken at this bill to this point, in fact. The other piece, aspect of the Treasury Department's objection to the bill makes me wonder the same thing actually. It seems to me that what we have been saying here and what we know from long and bitter experience is that the estate tax provisions of the Federal tax law have widespread pernicious influences on land use in this country. They force lands out of large units, they force fragmentation into smaller units, they force lands

out of family farms into subdivisions, they force lands that are providing a net benefit to the county tax rolls into the opposite situation as development is stimulated and the land holdings are fragmented, and each of these things has widespread public detriments in terms of loss of open space values, loss of wildlife, loss of watershed and fisheries values, loss of recreation opportunities, and so forth.

We know—what you have proposed here standing on the shoulders of Mr. Schulze is a bill that would—a modest bill that would begin to remedy some of those situations and the precise geographic situations in which development pressures are most severe and therefore the problem is at its worst. The experience of people in rural America, the experience of the farmers who have testified on this panel clearly shows that the incentives for conservation, donation of conservation easements under existing law and the effect on their ability to keep the land in farming use and to transfer the farm unit as a whole economic unit to the next generation and the next generation, is simply insufficient.

These are not effective remedies. If they were, these gentlemen would not be here. They would be on their farms where I am sure they would prefer to be today. So it seems to me that the Treasury Department's objections are simply misplaced, no more no less.

Mr. PAYNE. Any other comments?

Mr. BLOCH. I just want to second that, that the reduction that we could currently get now is probably not enough to allow us to keep the farm, that whatever appraisal we could possibly get after an estate, we don't know how long people are going to live. They might live a very long time, and we hope so, and the value of the estate lessened by whatever medical bills pile up in the meantime just may not be enough that we can keep the farm. So I second the gentleman's sentiments. And as far as the Treasury is concerned, I don't believe that the Bureau of Land Management could feed as many deer, turkey, quail, everything else and take the Cub Scouts fishing as cheaply as I can and pay taxes while I am doing it.

Mr. PAYNE. Thank you.

Mr. Lange, I think you commented already in your testimony.

As I conclude, I would like to just make one comment on something Mr. Thompson had said earlier, and that has to do with the revenue estimate of what this bill will cost. Last year a revenue estimate was done that suggested that this bill would cost $300 million over 5 years.

We looked at that, we decided that we needed to refine that. This bill is a somewhat narrower focus than the bill last year, in an attempt to reduce the revenue estimate. We were shocked when we got the most recent revenue estimate that said indeed this would cost now $5 billion over 5 years for a bill that is smaller in scope than the one last year that cost $300 million over 5 years. So we are continuing to work with the Joint Tax Committee and others to determine the methodology and to get the right answer. And I think Mr. Thompson indicated a computation that would suggest, as the rough calculations we have done, that the order of magnitude of the estimate is clearly far more than it should be, and we would hope to remedy that.

I want to thank all of you very much for being here. What you have said today will be an important part of the record as we proceed on these pieces of legislation. And I thank you for spending your time in coming here to give this information to us.

This subcommittee will recess until Tuesday, June 29, at 11, when we take testimony on tax issues affecting the health and safety of inner-city residents and other miscellaneous health tax-related issues.

[Whereupon, at 2:40 p.m., the hearing was adjourned, to reconvene at 11 a.m., Tuesday, June 29, 1993.]

MISCELLANEOUS REVENUE ISSUES

TUESDAY, JULY 13, 1993

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
SUBCOMMITTEE ON SELECT REVENUE MEASURES,
Washington, D.C.

The subcommittee met, pursuant to call, at 11:20 a.m., in room B–318, Rayburn House Office Building, Hon. Andy Jacobs, Jr., presiding.

Mr. JACOBS. We will convene the hearing of the Select Revenue Measures Subcommittee.

[By subsequent unanimous consent, the opening statement of Chairman Rangel follows:]

OPENING STATEMENT OF HON. CHARLES B. RANGEL, CHAIRMAN, SUBCOMMITTEE ON SELECT REVENUE MEASURES

Good morning. The Subcommittee on Select Revenue Measures meets this morning for the fourth of several days of hearings on miscellaneous revenue proposals.

The subcommittee today will receive testimony from public witnesses on revenue proposals described in the press release of June 2, 1993, relating to housing, tax-exempt bonds, individual, and compliance issues.

Because of the large number of witnesses who are scheduled to testify today, and so that there may be time for members to ask questions, I must ask that witnesses limit their oral testimony to 5 minutes. I realize that you cannot make all your points in 5 minutes, but be assured that your complete written testimony has been made available to the subcommittee members for review and will be entered into the record.

Mr. JACOBS. We are very honored to have a newcomer before us, Dan Rostenkowski of Iowa—no, Illinois.

Mayor, you are very welcome and I am sure you know you are very honored to have our leader alongside you.

You may have help somewhere along the line.

Chairman ROSTENKOWSKI. Thank you very much, Mr. Chairman. I am pleased to be a participant in this particular legislative program. I remember earlier this year we talked about what we could do with respect to the provisions that were in H.R. 11, and I understand that this is the last of a series of hearings that you are conducting with respect to the spending process that we are going through.

I heard Mayor Daley on other occasions discuss the bill that is presently before you. As a matter of fact, he did that quite effectively at an Illinois delegation luncheon about a month and a half ago. I know that there are certainly meritorious provisions that would create positive use of lands inside of urban areas and this is probably the answer to what could probably help redevelop inner cities.

I know that the cost question is also always a problem. We are here talking about cutbacks in Federal spending and yet this measure that the mayor will address is something that I can certainly see helping in urban areas.

And so, as you pointed out, Mr. Jacobs, I happened to meet the mayor in the hall and knew that he had some enlightening testimony to share with this subcommittee. So it is really a pleasure for me to introduce Richard M. Daley, who brings the Government a sincere effort with respect to trying to cut costs and serve the taxpayers.

I have lived in Chicago all my life and have been for a long time associated with the Daley family and I am proud today of this young man because I remember 35 years ago he was just a little boy.

Mr. JACOBS. I'll bet his father is very proud of this young man.

Chairman ROSTENKOWSKI. It is my pleasure, Mr. Jacobs, to introduce to this committee the Honorable Richard M. Daley, mayor of the city of Chicago, who is the number one citizen in our community.

Mr. Mayor.

STATEMENT OF HON. RICHARD M. DALEY, MAYOR, CHICAGO, ILL.

Mr. JACOBS. Mr. Mayor, we are very honored to have you here. Please proceed in your own fashion.

Mr. DALEY. Thank you very much, Mr. Chairman. Thank you, Congressman Rostenkowski, for that introduction. It is important for me to be here this morning, not only for Chicago, but also for small towns and communities of any size across the country dealing with the industrial problems that we have faced over the years.

It is important to note that we have lost in this country over 10 million industrial jobs since 1960. Unfortunately, millions of acres of farmland and wilderness have been consumed by runaway development, while prime urban property, suburban and rural industrial sites, are being abandoned everyday.

America can no longer be a throwaway society. The concept of recycling applies not only to bottles, cans and newspapers, but also to land infrastructure in communities. It applies, as well, to the people who worked in factories for decades before they were shut down. Many of them have lost their livelihood in the prime of their working years. Many cannot afford to relocate to new job sites and do not have the skills to transfer to new jobs.

This bill, H.R. 2340, attempts to address the bleak reality of America's industrial decline and the impact this decline has had on our environment and our people. I describe this land as the wastelands of America. Nothing would ever happen to these wastelands, not only in large urban areas like ours, but in the rural—in the suburban areas as well.

Just 6 weeks ago, Congressman Mel Reynolds and I announced this proposal at a site of a former International Harvester factory in Chicago. As it now stands, this site will not attract a new tenant because of its environmental problems that will cost over $1 million to correct. The International Harvester site is one of more than a

dozen large, abandoned, polluted industrial sites in Chicago and there are hundreds of smaller ones.

The problems include asbestos filled rubble, underground storage tanks, and hazardous waste. It is too expensive for the city to clean these sites and return them to productive use. The Federal Superfund process cannot possibly do it either, and private companies will not pay for it when they can get cleaner sites elsewhere outside the urban area.

This is one of the reasons why the Chicago area is unable to replace some of the 330,000 manufacturing jobs we have lost since 1960. It is the same story in once thriving industrial communities throughout America, whether large or smaller cities. Unless we find a way to clean up these sites, more jobs will leave the factory towns and cities of America. Some of those jobs will go abroad, while others will seek out undeveloped areas, resulting in unsightly inefficient sprawl, increasing automobile traffic and, of course, more pollution. Left behind will be unusable wastelands.

I describe them as neglected infrastructure surrounding the factories and workers without the skills or opportunities to rebound, the harsh reminders of a throwaway society which we can no longer afford to be. The proposal I have developed with Congressman Reynolds establishes an environmental tax credit for companies that agree to revitalize abandoned industrial properties.

Under the proposal, companies can get a tax credit of up to 25 percent of the cost of the cleanup. This legislation seeks a modest annual credit of $75 million nationwide during the 5-year life of the program. The program would apply to three categories: Large cities, medium cities, and small towns or rural areas.

It establishes a series of conditions before a city or town is approved for the program. Number one, the community must show extensive manufacturing job loss since 1970; two, it must have a high number of contaminated sites; and three, it must demonstrate a significant local commitment to addressing the problem of contaminated industrial sites.

And once a community has been selected, the site must also meet four additional criteria: One, the site must have been unproductive for at least a year; two, it must be shown that without this program, redevelopment would be unlikely; three, correspondingly, it must be shown that with the program there is a strong likelihood of redevelopment that will create jobs; and finally, remediation and redevelopment will have to be completed within a reasonable period of time.

Under the program, the city of Chicago will be eligible for about $6 million in Federal tax credits. This $6 million in Federal credits could leverage $24 million in private funds, which is enough to restore a dozen or more major industrial sites in the first year of this program.

The bill also authorizes jurisdictions to issue tax-exempt "environmental remediation bonds" to help pay for site acquisition and cleanups. It also requires a local contribution that can take the form of grants, loans, tax abatements, donation of property and other forms of financial assistance.

It further requires the developers to redevelop the site for commercial, I underline that, commercial, and industrial use to create

jobs. They must provide jobs or the tax credits would not be granted. The essential virtue of the bill is that it does not throw tax dollars at the problem.

Instead, it uses the Federal tax system to enlist the private sector in the cause of job creation and environmental cleanup. It trades $375 million in tax credits in the future for $1.5 billion in private sector investment over the next 5 years. By using the tax system instead of direct subsidies or grants, we are getting the private sector involved without bureaucratic interference or excessive oversight.

This way government is the catalyst for economic development instead of the cash cow. By creating a partnership among the private sector, local governments, and the Federal Government this bill distributes the burden of the cleanup costs. It also builds on our common interest in keeping good, solid manufacturing jobs in our cities and towns across America instead of simply driving them to new locations, or even worse, out of this country.

If the program is a success, it could be renewed, expanded after 5 years. If it doesn't work, I think we can try something else. One way or the other we must do something soon to recycle these properties and to restore them to productive use. We must do more to keep good jobs in America, to make America attractive for investments.

The city of Chicago has already begun this process and the initial results are positive. Today on the north side of the city of Chicago we are working to clean up a former industrial site. We are currently in contact with several companies that want to buy the site and build new factories.

Before we went there, no one would ever touch it. Now, we will probably put it out to bid. They will be competing for the site. The sale and the price of the land won't be the only bonus. The property will also go back on the tax rolls. There will be new jobs, and one thing we need more of in this economy is jobs.

The President called for an international job creation summit following the economic conference in Tokyo. This is one idea that should be considered and here is another example of how it can work.

On Chicago's southeast side, seven manufacturers set up shop on the site of a former steel mill. The city helped arrange financing, the private companies made an investment and today over 600 people are working in good jobs—jobs that can support their families.

These are two examples that show what can be done with our limited resources, but we cannot do it alone. In partnership with the Federal Government and the private sector we can expand this program in Chicago and throughout America. I think this bill is a good first step.

In doing so, we can help cities and towns retain the type of jobs that preserve and strengthen the middle class and broaden the tax base. We will be helping the business community grow and expand right here in America. We will be extending the usual life of an industrial infrastructure which is now being wasted as it sits idle.

We will be improving the environment for our children and their children. I think we can share all these common goals.

With me is Commissioner Valerie Jarrett of the Department of Economic Development of the city of Chicago and Henry Henderson, commissioner of the city's Department of Environment. We worked very closely on this bill. From my experience as a mayor, all of us, any elected official, as we travel throughout America and comb the wastelands, I don't know what we are going to do with these properties.

For example, in our city, an old tool and dye factory will close and put a fence around it that will say do not enter. They will not sell it, no one will buy it, because they are afraid to look into the ground. Once you look into the ground and open it up, you have the legal liability to clean it up. And so when we have someone who would like to reinvest in the city or in a smaller town or a community with this type of land, they would never look at it, with few exceptions, and we have a couple of exceptions in the city of Chicago. I appreciate any support you may give to this legislation.

Mr. JACOBS. Thank you, Mr. Mayor.

[The prepared statement follows:]

TESTIMONY OF MAYOR RICHARD M. DALEY, CITY OF CHICAGO, IN SUPPORT OF H.R. 2340, THE ENVIRONMENTAL REMEDIATION TAX CREDIT ACT OF 1993

Thank you Mr. Chairman for the opportunity to testify before this Subcommittee in support of H.R. 2340, the Environmental Remediation Tax Credit Act of 1993.

I am Richard M. Daley, Mayor of the City of Chicago. Together with Representative Mel Reynolds, we have developed the proposal contained in H.R. 2340. H.R. 2340 provides major incentives for cleaning up and redeveloping contaminated industrial properties through tax provisions and local government contributions. I am seeking this committee's support of this critical legislation.

Cleaning up contaminated sites and returning them to productive use poses a vexing problem for government at all levels. This is a problem I have grappled with since I have been in office. The costs of environmental remediation are prohibitively expensive for state and local governments; moreover, the Federal superfund cannot begin to cover all the sites that require clean up. Government programs will not, by themselves, solve this problem.

Ultimately, for sustained redevelopment to occur these sites must be made economically attractive to the private sector. Unfortunately, the potential large costs in cleaning up contaminated industrial sites has discouraged the private sector from purchasing and developing these properties. As a result, sites remain vacant with no hope of clean up in the future.

It is my view that modest modifications to the federal tax code, along with local assistance, are the simplest and least bureaucratic way to encourage direct private sector involvement in cleaning and redeveloping contaminated industrial properties.

The City of Chicago is one of many communities in the United States with numerous contaminated sites that could benefit from H.R 2340. The city is actively working to identify financing and incentives to redevelop contaminated property in the city.

To cite just a couple of examples of our problem:

- A six acre site in an industrial area is abandoned and long delinquent in its property taxes. It is a site for fly-dumping and violent crime. On it is a vacant, multi-story building constructed with asbestos materials. Beneath the land are a number of underground storage tanks. H.R. 2340 would make it feasible to redevelop the property and return it to the tax rolls; and

- A 20 acre site that, too, is a target of fly-dumping and other illegal activities. Abandoned buildings and

environmental contamination are present on the property. Industrial users in the area expressed interest in the property, but that interest waned in the face of expected high costs for environmental remediation. In this instance H.R. 2340 would help make the difference in rendering the redevelopment of the property economically viable for a new owner.

H.R. 2340 establishes a pilot program to clean up and redevelop contaminated industrial properties across the country. The bill provides a two prong tax incentive: tax credits and tax exempt financing to attract the private sector to redevelop a site for commercial or industrial use. H.R. 2340 would not affect current environmental laws.

The program would be undertaken in a cross section of communities: four large cities, 20 medium cities, and small cities and rural areas in five states. The selection would be based on a simple formula evaluating manufacturing job loss between 1970 and 1990; local commitment in remediating contaminated industrial sites; and the jurisdiction's share of contaminated sites as measured in the federally developed Comprehensive Environmental Response, Compensation, and Liability Information System list.

Selected communities would be able to allocate a non-refundable tax credit to participating businesses not responsible for the condition of the property. The tax credit would be allowed in annual installments over a five year period. To control costs, there is a national cap on the tax credit of $75 million per year. The three categories would share equally in the national annual tax allocation.

The amount of the tax credit allocated to each project would be capped at 25 percent of the total clean up costs as determined by a certified environmental audit; however, in the event the actual clean up cost is less than the cost specified in the audit, the amount of the tax credit would be reduced accordingly. Environmental remediation would be conducted in accordance with an U. S. Environmental Protection Agency approved plan. To ensure compliance, the first year the tax credit is available to the taxpayer would be the first year after completion of the clean up.

Specific sites eligible for a tax credit would be limited to sites designated by the state or local allocating agency. All designated sites would be selected on four minimum criteria:

- without this program redevelopment of the site is unlikely;
- the site has been unproductive for at least one year before participation in the program;
- there is a strong likelihood of industrial or commercial redevelopment of the site that will create jobs; and

- remediation and redevelopment are likely to be completed within a reasonable period of time.

The tax credit helps to make it more economical for a developer to clean up and redevelop contaminated property. While this incentive offsets a portion of the remediation costs, it does not completely eliminate the substantial competitive disadvantage for a contaminated parcel of land, as compared to an equivalent parcel that is not contaminated.

An additional incentive for clean up of contaminated properties is provided by making it possible to acquire the property and pay for clean up with tax exempt financing. The tax exempt bonds, "Environmental Remediation Bonds", could be issued to assist in the financing and clean up of selected sites. The bonds would be subject to existing volume caps. At least 60 percent of the proceeds would have to be used for remediation expenses. The portion of the proceeds used for acquisition could not exceed the appraised value of the property as cleaned up, less the cost of remediation.

Along with the tax provisions, local contributions also will provide incentives to attract the private sector to redevelop contaminated industrial properties. A participating city or state must have an established program that would contribute to the environmental remediation of a selected site. The local participation may take the form of grants, loans, property or income tax abatement, contributions by another non-federal agency, private party contribution, donation of property, or other direct or indirect financial assistance. A rural area or small community may utilize the state program to satisfy the local contribution requirement, so long as the state agrees to such a commitment.

H.R. 2340 would provide numerous major advantages to the public, including:

- It would help clean up and return to productivity sites that currently might never be cleaned up, providing jobs and tax revenue for state and local governments and their residents.

- It would promote private sector involvement in clean up efforts, lessening the need for government funding of environmental remediation.

- It would revive development where existing, underutilized infrastructure can be used, rather than being forced to undeveloped areas where significant expenditures must be made to construct new highways, transit, and other infrastructure.

- It would help reverse the trend of increasing urban sprawl, and curb the consumption of open lands.

Without these tax incentives, contaminated properties will remain polluted and unproductive for an indefinite period of

time. The economic base of communities will remain impaired, while the need for new growth will push urban areas ever outward.

H.R. 2340 directly involves the private sector and would lead not only to clean up but to actual industrial or commercial reuse of the property. This legislation also helps to promote more efficient use of existing infrastructure. With the ability to offset remediation costs, many of these sites will be reclaimable. This bill would be a cost effective and a successful tool in leveraging private financing to remediate these properties. The City of Chicago urges Congress to enact H.R. 2340.

Again thank you for the opportunity to testify in support of H.R. 2340.

Mr. JACOBS. Mr. Hancock.

Mr. HANCOCK. I don't have any questions, Mr. Chairman. Thank you.

Mr. JACOBS. It is a great idea. Admiral Halsey was quoted as saying it is better to know than to be ignorant, and it is better to build than to destroy. That came to mind during your testimony, Mr. Mayor, and sometimes—obviously, the advantage of what you propose is the word you use, the leverage.

During the 1980s there were certain kinds of leveraged activities that I do not admire. Most of us I hope do not. This is the kind that I think everybody should admire.

Mr. Reynolds, did you——

Mr. REYNOLDS. I just want to say, thank you, Mr. Chairman, and thank you, Mr. Mayor. This is a very important piece of legislation as far as helping the cities and cleaning up some sites around our city. As the mayor points out, what are we going to do with these sites if we don't find some way of cleaning them up?

I want to urge my colleagues to be in support of this.

Thank you very much.

Mr. JACOBS. Mr. Hoagland.

Mr. HOAGLAND. Let me just say, mayor, that there is a trade subcommittee hearing going on simultaneously and many of us would like to have been here to hear your testimony. I look forward to reviewing it and that of your colleague sitting with you at the table today.

So thank you. Thank you, Mr. Chairman.

Mr. DALEY. With me, Mr. Chairman, is Jim Martell, an industrial developer in the city of Chicago, and Charles Bartsch, senior policy analyst for the Northeast Midwest Institute. Jim has a real experience about these sites. As I travel throughout our city, I see half a block or 8 square blocks of abandoned property, and you can go to any city, large or small, and you see the same thing. The frustration is that Superfund is not going to do it.

My view as a mayor is to work more with the private sector and not just government alone. The key is working together with the private sector if you are going to try to solve these issues that affect especially the city that I am in.

Mr. JACOBS. Somehow I suspect you may have heard your father say that from time to time.

Mr. DALEY. I think so.

Mr. JACOBS. Mr. Martell.

STATEMENT OF JAMES G. MARTELL, SENIOR VICE PRESIDENT FOR INDUSTRIAL DEVELOPMENT, PRIME GROUP, INC., CHICAGO, ILL.

Mr. MARTELL. Jim. Thank you, Mr. Jacobs, for the opportunity to testify. I appreciate speaking on behalf of the great city of Chicago and Mayor Daley and Congressman Reynolds in support of bill H.R. 2340.

I am the senior vice president of the Prime Group, a private development firm that is based in Chicago with development offices and interests throughout the United States and also Western Europe. My principal function with the Prime Group is managing the industrial development activities that we embark on, focusing our

primary attention on the redevelopment of urban industrial projects throughout the United States, having completed a number of projects in the city of Chicago, northwest Indiana, Michigan, New Jersey, New York, and embarking on a pipeline of projects in other cities around the country.

The revitalization and the reuse of industrial sites is very important to the vitality and the health and well-being of the cities, urban centers that we are very so proud of. But it is also very important to the manufacturing community. The major trend and change in job development is not with the major Fortune 500 companies any longer.

The job creation is through small private manufacturing concerns and assembly firms that are growing as offshoots of these major companies.

It is very important for them to have facilities that are cost effective and can benefit them because of their location. They need to have a labor source. They need to be close to their markets. They need to have infrastructure in place. Infrastructure comes in many forms. It comes in the form of utilities, transportation links, shipping, truck, rail, and as we know, the growth of intermodal, which is the change in transfer of goods and services among all three, but also they need education and training facilities that provide the ongoing training, upgrading of the labor force.

In addition, they need to be close to their raw materials. They need to be close to their market, and most of all, all this has to be cost effective.

We have recently completed a project in the city of Chicago. Without the support and assistance of the city and their economic development department, it would not have enjoyed the success that it has. This was an abandoned former U.S. Steel facility on the southeast side of Chicago. The facility fortunately was not burdened with a tremendous amount of environmental concerns, but I think the success and the demand for facilities within the city of Chicago is the important story here.

With the help of economic incentives, enterprise zones, industrial revenue bonds, we converted 1.0001 million square feet of abandoned facility into homes for seven new companies employing over 600 people. The story here is that companies do want to locate in urban centers if they can find suitable facilities and if they can find them at a cost effective occupancy cost, and that was the story.

We leased over 1 million square feet of space and within 1 year's period of time have all those businesses up and occupied and manufacturing goods and services. This facility met all the criteria, as I outlined earlier, utilities, transportation links, educational facilities, close to the raw materials, within 25 minutes of downtown Chicago, and provided a below market occupancy cost compared to moving out to a green field site and replacing these facilities in the suburbs.

The obstacles standing in front of successful development and redevelopment are tremendous: the permitting process, the zoning process, et cetera. Developing a green field site today in suburban Chicago or anywhere probably takes up to 2 or 3 years and a series of 40 to 50 permits. Being able to take an infill site and develop that site within the city of Chicago, within any urban city, meets

the test of time and can go much quicker and faster because it is already zoned. There is the infrastructure in place. The employees are there. There is not the relocation of all those goods and services.

Unfortunately, one of the major barriers is environmental. Environmental concerns impede the flow of capital, impede the willingness of business to relocate and assume someone else's liabilities. No one wants to touch the environmental issue with the proverbial 10-foot pole.

Business today spends too much time on environmental issues, solving their own problems going forward. They do not want to solve somebody else's problems and take on the historical liabilities.

What we think H.R. 2340 does is convert those liabilities into assets. We can take those facilities, those sites and with the tax credits and the environmental bond, use those dollars to clean up these sites and turn that into an asset.

Mr. JACOBS. Thank you, sir.

STATEMENT OF CHARLES BARTSCH, SENIOR POLICY ANALYST, NORTHEAST MIDWEST INSTITUTE

Mr. JACOBS. Mr. Bartsch.

Mr. BARTSCH. Well, thank you for the opportunity to testify about H.R. 2340 and financial incentives to promote the reuse of industrial sites that have been contaminated.

My name is Charles Bartsch and I am senior economic development policy analyst at the Northeast Midwest Institute. The institute and the Northeast Midwest Coalition began working on the issue of industrial site reuse difficulties in 1991 as we realized its severity and potentially devastating impact on long established communities all over the country that have a history of manufacturing. In fact the organization's first significant efforts took place in Chicago, working with city officials there, Ted Wysocky and Ken Due and others. The institute did a cost-cutting analysis of the reuse issue which culminated in the report entitled, "New Life for our Buildings, Confronting Environmental and Economic Issues to Industrial Reuse," and last January the coalition convened a fact-finding forum in Chicago cochaired by Representative William Lipinski and Peter Visclosky.

The convergence of the needs, issues and opportunities of economic development and environment as reflected in H.R. 2340 comes at a critical time for old industrial areas all across the Nation, which as Mayor Daley has pointed out have lost 10 million manufacturing jobs since 1960 in response to changing markets, production technologies and a shift in the Nation's economic base.

Yet many of the manufacturing sites which once housed these jobs now lying abandoned or underused could be productively reused. These properties have the potential to house emerging technologies and manufacturing processes if they are rehabilitated. But the obstacles to their revitalization are daunting. Even if these sites have only small amounts of contamination, clean up adds significantly to the cost of a redevelopment project.

Depending on the extent and type of contamination, cleanup costs can often exceed $50,000 and can quite commonly reach $1

million or more. These expenses are not easily recovered, which places these sites and facilities at a tremendous disadvantage with green field locations.

Financing is a critical issue. There is a great need for targeted financial incentives to break the financing logjam which has stymied reuse to help level the economic playing field between brown field and green field sites. I am pleased that H.R. 2340 focuses on the financing component of reuse.

Public/private financial incentives are essential if the site reuse process is to go forward in a meaningful way in the Nation's old industrial cities. The complicated procedural and legal steps of testing, acquiring, cleaning and reusing industrial sites can be expensive and time consuming, and incentives like the tax credits and bond financing proposed in H.R. 2340 can help attract the necessary private capital for cleanup and preparation of these sites and facilities for structural renovations and for other necessary investments.

In a 1992 study based on reuse projects in 15 cities called, "Revitalization of Contaminated Industrial Sites," we at the institute concluded that achievement of industrial reuse on a large scale will involve the Federal Government in formulating a strategy that addresses the concerns of developers and investors in an environmentally responsible way.

Financial incentives are needed to encourage private companies to clean up contaminated buildings and invest new capital in them. Really the reuse issue boils down to one of simple dollars and cents. A manufacturer can acquire an untouched green field site probably in a new industrial park far from the central city and build a facility there to really suit his own purposes with minimal fuss.

Or that same manufacturer can acquire a previously used site in an old, largely abandoned, central city industrial district. The latter site, which is almost assuredly contaminated, is probably available to the manufacturer at little or no cost. However, the manufacturer will spend time and money having it tested to find out exactly what substances it contains, spend considerable time and money cleaning it up and getting it ready to build on, spend many more months pleading with the banker to lend on it, spend more time and money providing additional documentation and monitoring, and probably spend the rest of his natural life worrying about whether or not some as yet undetected contamination will surface undermining the value of the property and bringing with it potential costly liability claims.

In many areas, in fact, site preparation costs for longtime industrial sites in inner city areas typically run four times or more per acre the cost of the same size site in an urban industrial park. In short, the economic disadvantage of old industrial sites is significant. If the Federal Government intends to promote urban recovery and stimulate redevelopment and job generation in cities and provide a climate for private investment in manufacturing, it must offer financial incentives like those in H.R. 2340 to make old industrial sites economically competitive with newly established ones.

To reiterate a key point made by Mayor Daley, ultimately for sustained redevelopment to occur, these sites must be made eco-

nomically attractive to the private sector. The community and people advantages of the tax credits and tax-exempt environmental remediation bonds contained in H.R. 2340 have been well stated by the mayor and I concur with them.

Basically they would allow government to assume its traditional role as catalyst in the economic development process and give it the tools to establish productive reuse partnerships with the private sector to deal with the very serious economic development problem. I would like to commend Mayor Daley in representing the grounds for developing this approach to promote the reuse of old industrial sites. It can be a powerful weapon and a broad arsenal needed to attack the problems impeding site reuse and achieve the level of reuse all of us would like to see in Chicago and other industrial areas across the country.

Thank you.

Mr. JACOBS. Thank you, Mr. Bartsch.

[The prepared statement follows:]

STATEMENT OF CHARLES BARTSCH
OF THE NORTHEAST MIDWEST INSTITUTE

FINANCING INDUSTRIAL SITE REUSE PROJECTS:
THE ENVIRONMENTAL REMEDIATION TAX CREDIT ACT OF 1993 (H.R. 2340)

Thank you for the opportunity to testify about H.R. 2340 and financial incentives to promote the reuse of contaminated industrial sites.

I am Charles Bartsch, senior economic development policy analyst at the Northeast-Midwest Institute. The Institute and the Northeast-Midwest Congressional Coalition began working on the issue of industrial site reuse in 1991, as we realized its severity and potentially devastating impact on long-established communities with a history of manufacturing. Members of Congress, state officials, and local leaders recognized the need to get abandoned industrial properties back to productive use as part of a strategy to maintain business activity and job levels. In fact, the organizations' first significant efforts took place in Chicago. Working with city officials, Ted Wysocki and CANDO, and others, the Institute undertook a cross-cutting analysis of the reuse issue which culminated in a report entitled New Life for Old Buildings: Confronting Environmental and Economic Issues to Industrial Reuse. Last January, the Coalition convened a fact-finding forum in Chicago, co-chaired by Rep. William Lipinski and Rep. Peter Visclosky; a second forum is scheduled for next Monday in Cleveland.

Framing the Issue

The convergence of the needs, issues, and opportunities of economic development and environment, as reflected in H.R. 2340 and other Congressional initiatives, comes at a critical time for the Northeast-Midwest region. The revitalization and reuse of industrial sites is extremely important for the region, which has lost nearly 1.8 million manufacturing jobs since 1975 in response to changing markets, production technologies, and a shift in the nation's economic base. Yet many of the manufacturing sites which once housed these jobs, now lying abandoned or underused, could be productively reused. These properties have the potential to house emerging technologies and manufacturing processes if they are rehabilitated. Their adaptation to new uses could restore not only the buildings and their environment but also the jobs and vitality of the communities sourrounding them. Many of these sites are centrally located, and their reuse can take advantage of existing infrastructure systems and reduce suburban sprawl.

But the obstacles to their revitalization are daunting. Even if these sites have only small amounts of contamination, cleanup adds significantly to the cost of a redevelopment project. Depending on the extent and type of contamination, cleanup costs often exceed $50,000 and can reach $1 million or more. And these expenses are not easily recovered, placing these sites and facilities at a tremendous disadvantage with greenfield locations.

Impediments to Industrial Site Reuse and the Role of H.R. 2340

Over the past three years, we at the Institute--working in conjunction with the Congressional Coalition--have examined how the presence of contamination hinders the reuse of old, industrial properties and how these problems might be addressed. We have mapped out four factors that deter reuse

and tried to outline policies that could bring the disparate economic development and environmental interests together to work in a way that encourages site cleanup and allows reuse activity to go forward. Briefly, these four factors are:

1) need to clarify liabilities so that a new generation of "innocent landowner" defense can take hold and a new generation of "secured creditors exemptions" can emerge to address the problems banks fear and developers face when considering old industrial sites for redevelopment;

2) need for a clear, recognized, and expedited process for voluntary cleanups, which are needed if site reuse is to be viable as a community revitalization strategy on a more extensive scale;

3) need for broadly accepted cleanup standards and guidance that take into account variations between residential, commercial, and industrial uses and recognize that old manufacturing properties can remain industrial in their next use (in other words, recognize local land use decisions like those Chicago officials have made with their Planned Manufacturing Districts); and

4) need for targeted financial incentives for site reuse to break the financing logjam which has stymied reuse, to help level the economic playing field between brownfield and greenfield locations, and to attract the necessary private and public funds necessary to get projects off the ground.

H.R. 2340 focuses on this last critical issue, financing. Public-sector financial incentives are essential if the site reuse process is to go forward in a meaningful way in the nation's old industrial cities. The complicated procedural and legal steps of testing, acquiring, cleaning, and reusing older industrial sites can be expensive and time-consuming. Incentives like the tax credits and bond financing proposed in H.R. 2340 can help attract the necessary private capital for cleanup and preparation of sites and facilities, structural renovations, and other necessary investments.

In a 1992 study based on reuse projects in 15 cities, Revival of Contaminated Industrial Sites, we at the Institute concluded that: "Achievement of industrial reuse on a large scale will involve the federal government in formulating a strategy that addressed the concerns of developers and investors in an environmentally responsible way...Financial incentives are needed to encourage private companies to clean up contaminated buildings and invest new capital."

The reuse issue boils down to one of simple dollars and cents. A manufacturer can acquire an untouched greenfield site, probably in a new industrial park far from the central city, and likely build a facility to suit with minimal fuss. Or, that same manufacturer can acquire a previously used site in an old, largely abandoned central city industrial district. The latter site, almost assuredly contaminated, is probably available at little or no cost. However, the manufacturer will then spend time and money having it tested to find out exactly what substances it contains, spend considerable time and money cleaning it up and getting it ready to build on, spend more months pleading with a banker to lend on it, spend more time and money on providing

additional documentation and monitoring, and spend the rest of his natural life worrying whether some as yet undetected contamination will surface, undermining the value of the property and possibly bringing with it potentially costly liabililty claims. In many areas, in fact, site preparation costs for long-time industrial sites in inner city areas typically run four times or more per acre more than a site of the same size in a new exurban industrial park. In addition, the ongoing uncertainty of costs related to detection and cleanup of contamination complicate the financial picture of these operations even more.

In short, the economic disadvantage of old industrial sites is significant. If the federal government intends to promote urban recovery, stimulate redevelopment and job generation in cities, and provide a climate for private investment in manufacturing, it must offer financial incentives to make old industrial sites economically competitive with newly established ones. To reiterate a key point made by Mayor Daley: "Ultimately, for sustained redevelopment to occur, these sites must be made economically attractive to the private sector."

Private developers and investors, even if interested in acquiring an old property, are often thwarted by lenders concerned about devaluation of collateral and the effects of cleanup costs on a project's viability. Cleanup requires resources that many firms lack. In practice, tightened lending practices have led to de-facto redlining of older industrial sites in many areas. And without financing, private reuse projects can not go forward even if their proponents want to.

The community and people advantages of the tax credits and tax-exempt environmental remediation bonds proposed in H.R. 2340 have been well-stated by Mayor Daley and others, and I concur with them. They would allow government to assume its traditional role of catalyst in the economic development process, and give it the tools to establish productive reuse partnerships with the private sector to deal with this very serious economic development problem.

IV. Conclusion

I would like to commend Mayor Daley and Rep. Reynolds for developing this approach to promote the reuse of old industrial sites. It can be a powerful weapon in the broad arsenal needed to attack the problems impeding site reuse and achieve the level of reuse that all of us would like to see in Chicago and in other older industrial cities across the country.

Thank you for the opportunity to testify.

Mr. JACOBS. I have a substitution of engineers on the track, the Indiana, New York express.

Chairman RANGEL [presiding]. Let me apologize to this panel and I hope that Mayor Daley would assure Chairman Rostenkowski that I did get here in time to at least greet you.

I want to thank you, Mayor Daley, for all that you are doing as it relates to keeping the urban agenda on the map. There are so many people who are hostage to it. The work that you have done on the so-called empowerment zones as well as enterprise zones and the fact that you have constantly been able to point out to our President and the Congress demonstrates how important it is that we invest in human resources in order to prevent the great expenses that we have accumulated as a result of decades of neglect in causing our prisons, our hospitals, and our streets to be filled with the powerless.

So let me thank you. I apologize to the other two members of the panel for not being here and yield to my colleague, Mr. Hancock for any questions.

Mr. HANCOCK. I don't have any questions.

Chairman RANGEL. Mr. Jacobs.

Mr. JACOBS. I wanted to ask Mr. Bartsch, have you any statistics on the number of sites related to this legislation that there might be throughout the United States?

Mr. BARTSCH. There is no really good number available because there is no really good reporting requirement for sites that may be contaminated that the owners just choose not to do anything with for whatever reason. But the General Accounting Office has suggested that as many as 500,000 sites across the country could have contamination that would really impede their reuse. I think this is just a good first step.

Mr. DALEY. In the west side of the city of Chicago, where we had the old tool and dye industry, much property has been abandoned. You will never sell it. You would never ever buy the property because you don't know what is in the ground. They have storage tanks they have had over the years—you know, for 50 or 60 years, this company had put things in the soil that no one knows about.

So what they do is fence it in and no one reports it because it is abandoned property. As you fly over a city or take a train through a city or go through a river town, you will see a piece of property, an abandoned factory. No one in his right mind is going to purchase it because of the cost of cleanup. It is multiplying.

Mr. JACOBS. That leads to my next question. That is, if there are a half million sites throughout the United States, there has already been a revenue estimate about this legislation, one wonders what number of sites the estimate relates to.

Mr. DALEY. I think this is a limited proposal that deals with some large urban areas and some smaller towns and rural areas on a 4- or 5-year commitment. The bill is really job creation and economic development.

Mr. JACOBS. It really becomes, I think you suggested in your testimony, Mr. Mayor, it really becomes something like a pilot project.

Mr. DALEY. Right.

Mr. JACOBS. Find out. In theory it sounds like cake.

Mr. DALEY. At the mayors' conference we had a coalition of mayors from the smallest city to medium cities and large cities who really looked at this bill because you go to any city and they have just lost a factory, 200 or 300 people, and they have lost tax revenue, they lost jobs, and no one is going to purchase the property. It is just abandoned.

And so we have a coalition of mayors all across the country.

Mr. JACOBS. I have two questions of Mr. Martell. Do you know, your name seems unusual. Are you aware there is an Arlene Martell who is one of the top network commercial singers in the United States? Are you honored to know that, sir?

Mr. MARTELL. I am, thank you.

Mr. JACOBS. The two questions are, first, you cited an estimated 3 years for establishment of a new plant in suburbia and by comparison there would be less time through this system. How much less time would you estimate for the record?

Mr. MARTELL. We went from about 12 months to 14 months in developing the Chicago Enterprise Center, as we call it, and taking basically an abandoned factory and turning it into 600 jobs, because the property is zoned and the facility—the basic infrastructure is there and it is just a matter of adding the components that the market demands to make that space tenantable.

Mr. JACOBS. That is good to have on the record. You know the Treasury Department objects, and I think the gravamen of the objection is what they call complexity. You are in the business. Let's hear something about that.

Mr. MARTELL. About complexity?

Mr. JACOBS. Complexity. They object to it because they say it would be too complex for businesses to bite.

Mr. MARTELL. In terms of the performance of this bill——

Mr. JACOBS. Yes, establishing the criteria necessary to be eligible, so on.

Mr. MARTELL. I think the establishment is pretty obvious actually. If you were to tour most major cities, I think it becomes readily available what is abandoned, and the reason that it is abandoned is some form of obsolescence and environmental problem.

I think you can very readily identify qualified projects within a community knowing the city of Chicago and knowing some of the projects the mayor has identified. Yesterday I was meeting with a firm in Boston that has a contaminated site in Phoenix. They are all over.

So I think that we have already had many of them identified by the EPA and Illinois EPA and different State organizations know what some of the more contaminated sites. Then the private sector will also bring those forward as we identify projects.

We are working with the department currently on another project in the city where we are assembling some land and there is some contamination, and we need assistance to solve those problems. So I think identifying projects is the least of our concerns. I think having the incentives to clean up those sites and make them competitive is really where this bill lies and where it is going to do its job.

Mr. JACOBS. With all due respect to our friends at Treasury, we have a political saying in Indiana, if they are going to be against

the thing, they can always find a reason, and I wanted that response on the record.

Mr. Chairman, I yield back.

Chairman RANGEL. Thank you. And let me take this time to once again thank the panel for its testimony.

Mr. DALEY. Thank you, Mr. Chairman.

Mr. MARTELL. Thank you, Mr. Chairman.

Chairman RANGEL. Mr. Reynolds.

Mr. REYNOLDS. I just wanted to make one point, Mr. Chairman. That was, as far as sites around the city, there are lots of sites like that. On the south side of Chicago in my district we have several that have just gone on, and on, and on, and we must do something to revitalize these sites.

Thank you, Mr. Chairman.

Chairman RANGEL. Is anyone else seeking recognition?

Mr. Jefferson.

Mr. JEFFERSON. No, sir.

Chairman RANGEL. Then thank you once again.

Mr. DALEY. Thank you, Mr. Chairman.

Chairman RANGEL. Mr. Reynolds will then be the next witness.

Mr. Jefferson, do you have an item you wanted to get on the agenda?

Mr. JEFFERSON. Yes, sir. I will come see you.

Thank you.

[By subsequent unanimous consent, the statements of Representatives Ford, Johnson, and Matsui were inserted at this point in the record:]

TESTIMONY OF CONGRESSMAN HAROLD FORD
BEFORE THE
COMMITTEE ON WAYS AND MEANS
SUBCOMMITTEE ON SELECT REVENUE MEASURES

July 13, 1993

A PROPOSAL TO REVITALIZE THE ECONOMICALLY DISTRESSED CENTRAL BUSINESS DISTRICTS (CBDs) IN MEMPHIS, TN AND SIMILARLY SITUATED CITIES THROUGH THE RESTORATION OF THE HISTORIC REHABILITATION TAX CREDIT

Mr. Chairman, Members of the Subcommittee, I want to thank you for the opportunity to appear before you and provide testimony on an important legislative initiative under consideration. I have proposed an urban tool for the revitalization of central business districts that fall in economically distressed areas of our cities. Through the restoration of the historic rehabilitation tax credit, we can stimulate job creation, private investment, tourism and a renewed interest in the historic heritage of our cities.

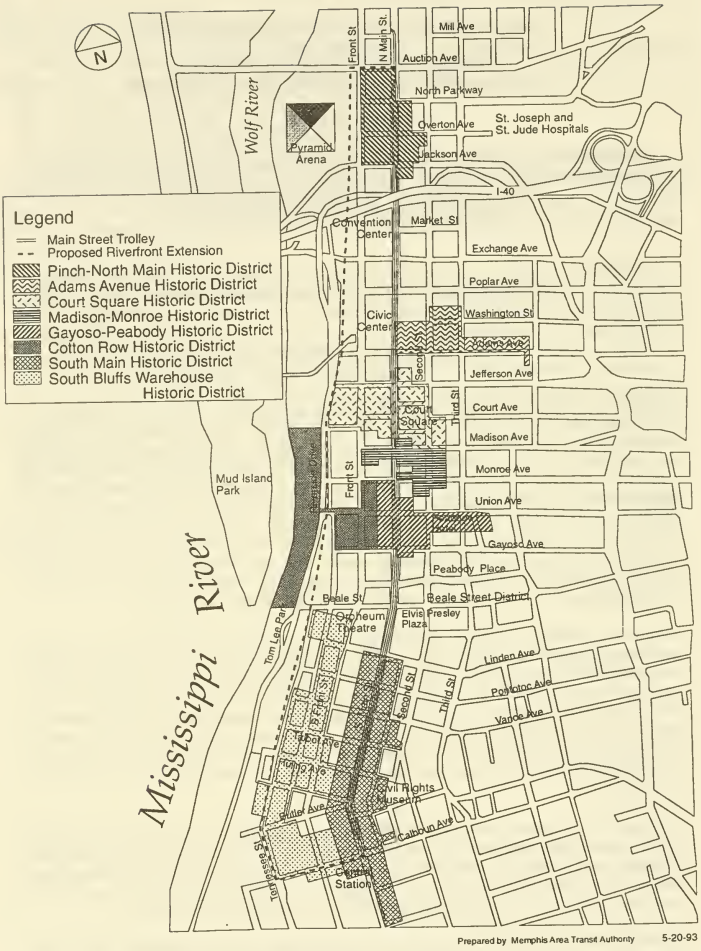
Given the present budget situation, we must target tax incentives to the historic preservation of projects in our cities. The purpose of the legislation would be to provide relief from the changes in the 1986 Tax Code which made it impossible for the program to be effective. As you know, the tax credit was subject to the passive loss rules whereby the credit was reduced and taxpayers with incomes above a certain level were unable to take advantage of the credit.

The revival of the historic rehabilitation tax credit, which had heretofore been one of the most effective tools for the infusion of capital into our urban centers, would have a significant impact on the development of our cities. Since it was first enacted in 1978, $16 billion in private investment was directed into 25,000 preservation projects.

Like other proposals, I propose the raising of the allowable credit from $7,000 to $20,000 and eliminate the income cap. This would dramatically increase the pool of investors and the amount they invest, which would in turn create jobs, affordable housing and a return to economic vitality. Unlike other proposals, my proposal is aimed at the revitalization of the central business districts in economically distressed areas. Specifically, the proposal would apply to eight districts that either cross or abut Main Street in Memphis, TN, an area that has been placed on the National Trust for Historic Preservation Register. The credit would be a powerful vehicle for generating quality jobs, which as most of us know, are virtually nonexistent.

Investment in our inner cities and historic central business districts through the restoration of the historic rehabilitation tax credit will have a direct effect on creating jobs in the Ninth Congressional District and other districts. If the central business district of an economically distressed area has buildings designated as historic sites or has buildings falling within an area designated as an historic site, eligibility for the tax credit would attach.

It has been noted that for $1 billion dollars the government spends for highway construction, 52,000 jobs are created. An analyses based on the Department of Commerce data projects found that if this same money was used for the historic rehabilitation tax credit, 175,000 jobs would be produced. With President Clinton's endorsement of a jobs summit to be held in the fall, we can all do our part by helping to create jobs in our districts.


Legend
Main Street Trolley
Proposed Riverfront Extension
Pinch-North Main Historic District
Adams Avenue Historic District
Court Square Historic District
Madison-Monroe Historic District
Gayoso-Peabody Historic District
Cotton Row Historic District
South Main Historic District
South Bluffs Warehouse Historic District
N
Wolf River
Pyramid Arena
Front St.
N Main St.
Mill Ave
Auction Ave
North Parkway
Overton Ave
St. Joseph and St. Jude Hospitals
Jackson Ave
I-40
Convention Center
Market St
Exchange Ave
Poplar Ave
Civic Center
Washington St
Jefferson Ave
Second St
Third St
Court Square
Court Ave
Madison Ave
Monroe Ave
Union Ave
Gayoso Ave
Peabody Place
Beale St
Beale Street District
Orpheum Theatre
Elvis Presley Plaza
Linden Ave
Poplar Ave
Vance Ave
Mud Island Park
Mud Island Drive
Mississippi River
Tom Lee Park
B.B. King St
Beale St
Second St
Third St
Civil Rights Museum
Calhoun Ave
Central Station
Tennessee St
Prepared by Memphis Area Transit Authority
5-20-93

NANCY L. JOHNSON
6TH DISTRICT, CONNECTICUT

COMMITTEE ON WAYS AND MEANS
SUBCOMMITTEES:
HEALTH
TRADE
COMMITTEE ON
STANDARDS OF OFFICIAL CONDUCT
CO-CHAIR
EXPORT TASK FORCE

Congress of the United States
House of Representatives
Washington, DC 20515-0706

WASHINGTON OFFICE:
343 CANNON HOUSE OFFICE BUILDING
WASHINGTON, DC 20515-0706
TELEPHONE: (202) 225-4476

NEW BRITAIN OFFICE:
480 MYRTLE STREET—SUITE 200
NEW BRITAIN, CT 06053
TELEPHONE: (203) 223-8412

ENFIELD OFFICE
278 HAZARD AVENUE
ENFIELD, CT 06082
TELEPHONE: (203) 745-8722

STATEMENT BY THE

HONORABLE NANCY L. JOHNSON

BEFORE THE SUBCOMMITTEE ON SELECT REVENUES

JULY 13, 1993

Good morning, Mr. Chairman and colleagues. I appreciate the opportunity to appear once again on behalf of my Connecticut constituents. Today, I raise an issue that I unsuccessfully offered during the full Committee's reconciliation markup that would help the unemployed. In my state, unfortunately, the number of folks out of work is painfully high; and, with defense conversion only proceeding in fits and starts, may get worse before it gets better.

Under current law, those receiving unemployment compensation pay federal taxes on that income either quarterly or on the following April 15. There is no mechanism for automatic withholding of federal income taxes from unemployment insurance [UI] checks.

My proposal, which is completely voluntary, would allow UI recipients to elect withholding at the 15% rate and is designed to address at least two troublesome situations in this area.

First, many people are unaware that UI benefits are taxable income. Though I do not dispute the tax treatment of these benefits, I believe it imperative that we acknowledge the lack of information in the population at large and give people the option to have taxes withheld from their UI checks.

Second - and this is readily apparent in Connecticut and most other states - two-earner families are the rule, not the exception. Thus, when an unemployed spouse is collecting UI, he or she is incurring a joint liability that may not only be unexpected but also hard to meet the following April.

Mr. Chairman, this is a sensible amendment to the code that gives UI recipients a useful choice. It allows those people who exercise the withholding option the opportunity to meet their federal obligations in a timely manner and avoid unpleasant surprises. I hope the Committee will see fit to approve this language.

Thank you again for the opportunity to testify this morning.

Statement of
The Honorable Robert T. Matsui
before the
House Ways and Means Subcommittee on Select Revenue Measures
July 13, 1993

Good morning, Mr. Chairman and members of the subcommittee. I have introduced legislation (H.R. 2022) which would make two important changes in the tax code that are critical to the health and continued viability of colleges and universities across the nation. This bill would modify the characterization under current law of bonds issued by independent colleges and universities as "private activity" bonds. The bill would also remove the $150 million limit on the amount of non-hospital tax-exempt bonds that a nonprofit organization could have outstanding at any one time.

The 1986 decision to recharacterize tax-exempt bonds issued by private nonprofit colleges and universities as "private activity" bonds has significant tax policy implications, and is deeply troubling. The congressional ambivalence about this modification was apparent, when, in the conference report to the 1986 Act, the conferees wrote that they:

> recognize that section 501(c)(3) organizations typically perform functions which governments would otherwise have to undertake. The use of the term private activity bond to classify the obligations of section 501(c)(3) organizations in the IRS in 1986 in no way connotes any absence of public purposes associated with their issuance.

Unfortunately, the classification of bonds issued by independent colleges and universities as "private activity" bonds does connote a lack of public purpose for several reasons. This characterization draws a sharp and inappropriate distinction between private nonprofit colleges and universities and their public counterparts, and it equates bonds issued by colleges and universities with profit-making ventures. The equality between public and private higher education with regard to public-purpose mission requires equal access to tax-exempt financing.

In addition to the recharacterization of these bonds, the second significant feature of this legislation is the elimination of the $150 million limit on the amount of non-hospital tax-exempt bonds from which a 501(c)(3) organization may benefit. This special limit, imposed by the 1986 Act, has precluded access to tax-exempt financing for a number of outstanding independent colleges and universities across the country. In addition, the $150 million limit addresses a congressional objective that was addressed and achieved by other tax rules contained in the 1986 Act.

The House version of the Tax Reform Act of 1986 contained this $150 million limit as a "wealth test" on independent colleges and universities

benefitting from tax-exempt bonds. The suggestion that independent colleges and universities be subject to a wealth test to prevent arbitraging likely arose from the historical practice of these institutions of maintaining endowments as a funding source to ensure their continued ability to operate. The earnings from an endowment are, in effect, substantially similar to the annual appropriations received by governmental colleges and universities. Nonetheless, the existence of endowments gave rise to the perception that private colleges and universities were involved in economic arbitrage.

This committee, when determining tax policy, has always attempted to treat similarly situated individuals or groups similarly. Unfortunately, this $150 million limit fails this test. It imposes different rules on independent colleges and universities than their public counterparts, despite the fact that both public and independent institutions have identical public purpose missions. The cap also imposes limitations on vastly different types of institutions, which were in all likelihood not intended when the rule was drafted. Large institutions without similarly large endowments are restricted in their access to capital, all by virtue of the fact that they have significant facilities needs.

Perhaps even more disconcerting is the impact that this limit has had on smaller institutions. These institutions traditionally have not required a sufficient amount of capital to justify the significant costs of issuing their own tax-exempt bonds. However, in a number of states, these smaller institutions have been able to participate in pooled financings. In these types of arrangements, a larger institution serves as the primary issuer, and is able to absorb a significant share of the initial costs of issuing the obligation. These smaller institutions are then able to "pool" their limited resources with the resources of the larger institution and gain access to the tax-exempt bond market. The $150 million limit, since it precludes many of the larger institutions from entering the tax-exempt bond market, also precludes smaller colleges and universities from obtaining the benefit of tax-exempt financing which Congress has historically granted all 501(c)(3) organizations, regardless of size.

It is also important to recognize that other changes made by the 1986 Act have made the $150 million limit unnecessary. The 1986 Act included a number of modifications to tax-exempt bond rules for 501(c)(3) organizations, including arbitrage rebate requirements, as well as bond maturity, hedge bond, and advanced refunding restrictions. These changes, as well as the public approval requirements enacted in the Tax Equity and Fiscal Responsibility Act of 1982, render the $150 million limit obsolete.

Mr. Chairman, member of the subcommittee, I hope we can move this legislation expeditiously. Thank you for considering it.

STATEMENT BY
THE HONORABLE ROBERT T. MATSUI
CALIFORNIA, FIFTH DISTRICT
REGARDING AN AMENDMENT TO ALLOW STANFORD UNIVERSITY
TO USE ALREADY ISSUED TAX-EXEMPT BONDS FOR EARTHQUAKE RECOVERY

July 13, 1993

The 1986 Tax Reform Act contained language permitting Stanford University to issue up to $105 million in tax-exempt bonds, notwithstanding the $150 million cap the Act imposed on the issuance of such bonds by private universities. The language in the Act specified that the bonds were to be for the construction and renovation of student housing and research facilities on the campus.

I am today requesting an amendment to permit Stanford to use a portion of the proceeds of those bonds, approximately $50 million, to help the university recover from the severe damage it suffered in the 1989 Loma Prieta Earthquake. That earthquake, which hit the Bay Area weeks after the bonds were sold, caused well over $100 million in damage to the campus. Over 200 structures on the campus were damaged, and over twenty major buildings were closed as unsafe for occupancy as a result of the earthquake. Many of these buildings--including the main library --remain closed.

Because of the significant financial and capital pressures created by the earthquake and the need to accelerate its seismic bracing program, the university has been forced to postpone previously planned projects so that it can devote its resources to repairing damaged buildings and to structurally strengthening others. The university simply cannot afford to undertake the projects for which the original bonds were issued, but it badly needs capital to help finance its recovery from the earthquake.

Examples of projects which might be financed from the bond proceeds if the proposed amendment is accepted include the repair of buildings that were damaged in the earthquake, the construction of new facilities to accommodate departments that were displaced by the earthquake, and the structural bracing of buildings that were not damaged in the earthquake. The proposed amendment would also exempt the bonds used for earthquake projects from TEFRA notice and hearing requirements contained in section 147 (f) of the Internal Revenue Code, since these requirements can only be fulfilled before the bonds are issued.

I would like to stress that this amendment will cost the federal government nothing. The bonds have already been issued. This amendment will merely allow Stanford to use tax-exempt bonds that have already been issued to help finance its recovery from a major earthquake. I urge that the following amendment be enacted.

Proposed Amendment:

(A) Subparagraph (J)* of paragraph (33) of Section 1317 of the Tax Reform Act of 1986 is amended to read as follows:

(J)(1) Proceeds of an issue are described in this subparagraph if--

(i) the issue is issued on behalf of a university for which the founding grant was signed on November 11, 1885, and

(ii) such proceeds are to be used for a Near West Campus Redevelopment Project; a Student Housing Project; renovation, repair, construction, reconstruction or acquisition undertaken or made as a result of an earthquake; and/or seismic bracing.

The aggregate face amount of bonds to which this subparagraph applies shall not exceed $105,000,000.

(B) Bonds the proceeds of which are to be used for the purposes specified in clause (ii) of subparagraph (J)(1) of paragraph (33) of Section 1317 of the TAx Reform Act of 1986 as amended in (A) hereof shall be deemed to comply with the provisions of SEction 147(f) of the Internal Revenue Code.

Thank you for your consideration of this amendment.

Chairman RANGEL. Mr. Reynolds, we welcome your testimony. You may proceed in the manner that you feel most comfortable.

STATEMENT OF HON. MEL REYNOLDS, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF ILLINOIS

Mr. REYNOLDS. Thank you, Mr. Chairman. Mr. Chairman, distinguished Members of the subcommittee, thank you for providing me the opportunity to testify before you this morning.

I come before you today to urge support of H.R. 494, which provides certain limited tax benefits to our men and women serving as part of Operation Restore Hope in Somalia. The legislation has generated bipartisan support.

I visited Somalia in December of 1992 and met many men and women of our armed forces who were bringing relief to the people of Somalia. In my discussions with them about their work, many of them raised the difference in how they were taxed on their pay while serving in Somalia as compared to when they served in the Persian Gulf as part of Operation Desert Storm.

They told me that Operation Desert Storm was declared a combat zone by then President Bush, while Operation Restore Hope had not been.

A Presidential declaration of a combat zone carries certain tax benefits to those members of the armed forces serving directly in or in support of that zone. The area in Operation Restore Hope has never been declared a combat zone by President Bush or President Clinton.

Therefore the soldiers serving in Somalia incur a tax burden that they otherwise would not were the area of operation in Somalia declared a combat zone.

Specifically, a presidential declaration of a combat zone triggers the following benefits in the Tax Code. Section 112, exclusion of combat pay from calculation of gross income; Section 692(a), forgiveness of income taxes in the case of combat-related death; Section 2201, forgiveness of estate taxes in the case of combat-related death; Section 7508, postponement of a filing deadline for taxes; and Section 3401(a)(1), exemption of combat pay from income tax withholding.

According to the Joint Tax Committee's estimate, enactment of this modest legislation would cost $31 million over 5 years, with all the cost projected to occur in the first year.

H.R. 494 seeks to provide our soldiers with nothing more and nothing less than that accorded our soldiers in the Persian Gulf. The issue here is one of equality of treatment and fairness. While understanding the underlying differences between Operation Restore Hope and Operation Desert Storm, there are many common factors and similar situations faced by the soldiers.

It is because of the common elements of the two operations that I believe those who serve in Somalia should receive similar tax treatment.

There is precedent for some form of legislative relief. The Ways and Means Committee approved, and the Congress enacted a provision in the 102d Congress to extend the period of time for soldiers in the Persian Gulf to file their taxes. No other remedial legislation

was necessary at that time due to the designation of the area of operation in the Persian Gulf as a combat zone.

If we are to treat our soldiers in Somalia in the same way that we have treated soldiers in other operations, we need to enact this legislation.

Clearly, Mr. Chairman, the men and women of our armed forces who serve in Somalia face the same type of danger as these same men and women faced in the Persian Gulf, yet because of a technicality, their tax burden is quite different. Absent a presidential declaration of Somalia as a combat zone, the soldiers who serve there will face a greater tax burden than they faced in the Persian Gulf.

Mr. Chairman, this legislation is very straightforward and is the least we can do for the men and women of our armed forces who face danger every day while bringing hope and relief to the people of Somalia.

I thank the Chairman.

Chairman RANGEL. Thank you.

Is your bill restricted to just providing tax benefits to these veterans?

Mr. REYNOLDS. Yes.

Chairman RANGEL. These soldiers?

Mr. REYNOLDS. Yes, it is. It is the soldiers serving in Somalia and those serving in support of——

Chairman RANGEL. But you don't declare them as being declared for all purposes as being combat soldiers?

Mr. REYNOLDS. No, I do not. It just as relates to——

Chairman RANGEL. What distinction do you make between giving them partial benefits and not being declared as combat soldiers?

Mr. REYNOLDS. What we wanted to do was give them the exact same benefits that were given to the soldiers that fought in Operation Desert Storm.

Chairman RANGEL. Operation Desert Storm, was that restricted to just tax benefits and no educational or medical? Because generally speaking, combat soldiers receive more benefits than just tax breaks.

Do you have the support of any of the veterans' associations? Because you are walking in a very delicate and sensitive area among veterans.

Mr. REYNOLDS. They have called us and quite frankly have voiced their support. We have had many senior Members as well sign on as cosponsors of this legislation.

Quite frankly, I have gotten letters from some of the soldiers I met in Somalia thanking us for putting this forward. They don't feel that it is fair that they should be under the same kind of threat of life and not receive the same tax benefits.

Chairman RANGEL. I wasn't really talking about the beneficiaries. I was talking about these old line veterans.

Mr. REYNOLDS. Organizations? We have gotten nothing but a positive response from them.

Chairman RANGEL. Very good. Now, it is my understanding that this bill would not terminate the benefits except by executive order?

Mr. REYNOLDS. Yes.

Chairman RANGEL. Why would you not have an expiration date so that the costs can be better determined?

Mr. REYNOLDS. We just—as I said, we wanted to basically have it the same way as the soldiers in Desert Storm. By the way, Sonny Montgomery is one of my cosponsors of this legislation who is, as you know, Chairman of the Veterans Affairs Committee.

Chairman RANGEL. I don't think he would go too far without the veterans' organizations.

Mr. REYNOLDS. I don't think so either.

Chairman RANGEL. Mr. Jefferson?

Mr. JEFFERSON. No, sir, I don't have anything.

Chairman RANGEL. Let me thank you for the outstanding contribution that you are making. I think that to a spouse or child who loses someone in Somalia that the pain is there as if they lost them in Panama or in the Persian Gulf, and we will see what we can do with the bill.

Thank you for your testimony.

Mr. REYNOLDS. Thank you, Mr. Chairman.

Chairman RANGEL. Mr. Charles E.—is that E.? Charles E. Schumer, MC, New York. The Honorable—I so apologize. The Honorable Charles E. Schumer.

Thank you for gracing this room and this committee with your presence, your intellect and the contribution that I know you are going to make as we look through these miscellaneous pieces of legislation.

Your statement is going to be entered into the record in its entirety by unanimous consent and you may read the statement and then give another statement or you may just bypass the written statement and just give your oral statement.

STATEMENT OF HON. CHARLES E. SCHUMER, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NEW YORK

Mr. SCHUMER. Three or four statements?

Chairman RANGEL. You may give a combination of both statements.

Mr. SCHUMER. Thank you very much, Mr. Chairman. I will try to summarize my statement and then give several other statements on extraneous issues, maybe the spotted owl or a few other issues that I care to grace the committee with.

Chairman RANGEL. Whatever you talk about.

Mr. SCHUMER. What I am really here to testify about today is in strong support of legislation to prevent the imposition of a particularly unfair and onerous tax on housing co-ops. The IRS has taken the position that Section 277 of the code, a section that Congress never intended to apply to housing co-ops, allows taxes to be levied on cooperative income which is functionally tied to the provision of the housing.

Now, this subcommittee has measures before it which clarify that 277 of the code doesn't apply to housing co-ops. One of these measures, I might add, Mr. Chairman, is H.R. 1908 introduced by a very well-known, powerful, erudite person in the Congress.

Chairman RANGEL. Who is that?

Mr. SCHUMER. I think it is Charles B., is it B. Rangel? Yes, and——

Chairman RANGEL. I don't think you have to go any further really.

Mr. SCHUMER. I know you have played a leading role in this. I have introduced H.R. 537, a bill slightly different than 1908 but having much of the original wisdom contained in 1908 and it seeks the identical goal.

I don't have to tell you, Mr. Chairman, in New York co-ops are very important to us, especially to low- and middle-income Americans, and they have been devastated by this law. Trump Village, for instance, which is in my district, you have to have an income below $20,000. About 55 percent of the households in Trump Village are over 60 years of age. Of that number, 75 percent are 75 years of age and yet the IRS is claiming under 277 that Trump Village owes $3 million in back taxes alone.

This is due to the fact that the Mitchell-Lama housing regulations require Trump Village to build up a reserve fund in order to pay for the repairs needed for the aging building. So in order to pay the sum, because they had to build up the reserve, they are now taxing them because they had to build up reserve. Trump Village co-operators would have to pay double the carrying charges now paid, and the carrying charges now for these people are very high.

So I don't know how many of the seniors and others living in Trump Village will be able to come up with that kind of money. I just give that as an example in my district, which I know is repeated in yours and districts throughout the country. This position of the IRS is even more inequitable when the original intent of 277 is considered.

When it passed in 1969 it was intended to apply to membership organizations like country clubs, which had a large amount of nonmembership income that was going untaxed. 277 was properly intended to prevent the country clubs from sheltering taxable income. But when in 1990 the IRS decided that since housing co-ops were technically membership organizations, of course they are the housing, they are the roofs over people's heads, so it is not the same kind of discretionary organization. They basically said that housing co-ops should be treated like country clubs.

I know I don't have to tell you, but maybe to some of the other Members that are not aware, in many parts of the country and in our city, these are working people who are scratching out a living where they live, and now to tax them as if this income is the same as somebody who joined a country club and had this other income is very, very unfair.

I would also urge one other thing. That is that whatever legislation we do, repeal the damage the IRS has done in previous years as well as the prospective change. As I mentioned, they would have to pay $3 million. I know that many other co-ops would have to pay even more if it wasn't done retroactively.

With that, I would just submit my written statement into the record. I will waive the right to expostulate on all these other issues which are right on my mind at the moment. I thank the committee very much for hearing us and letting us make our pleas on legislation that is very important to us.

[The prepared statement follows:]

CHARLES E SCHUMER
10TH DISTRICT NEW YORK

WASHINGTON OFFICE
2412 RAYBURN HOUSE OFFICE BUILDING
WASHINGTON, DC 20515-3210
(202) 225-6616
TELEFAX (202) 225-4183

BROOKLYN OFFICE
1929 KINGS HIGHWAY
BROOKLYN NY 11229
(718) 965-5400
TELEFAX (718) 965-5289

Congress of the United States
House of Representatives
Washington, DC 20515-3210

COMMITTEES
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SUBCOMMITTEE ON
CRIME AND CRIMINAL JUSTICE

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NEW YORK STATE
DEMOCRATIC DELEGATION
TREASURER

WHIP-AT-LARGE

July 13, 1993

STATEMENT OF CONGRESSMAN CHARLES E. SCHUMER
BEFORE THE SUBCOMMITTEE ON SELECT REVENUE MEASURES
COMMITTEE ON WAYS AND MEANS

Mr. Chairman and Members of the Subcommittee:

I am here to testify before you today in strong support of legislation to prevent the imposition of a particularly unfair and onerous tax on housing cooperatives. The Internal Revenue Service has taken the position that Section 277 of the Internal Revenue Code - a section that Congress never intended to apply to housing cooperatives - allows taxes to be levied on housing cooperative income which is functionally tied to the provision of housing. This

subcommittee has before it measures which clarify that Section 277 of the Internal Revenue Code does not apply to housing cooperatives. One of these measures is H.R. 1908, introduced by the Chairman of this Subcommittee who has played the lead role in including this proposal in the tax bills of past sessions. I have also introduced H.R. 537, a bill which is slightly different than H.R. 1908, but seeks the identical goal of correcting this mistaken I.R.S. position.

In New York, as well as in many communities throughout this nation, housing cooperatives make up a significant portion of the affordable housing available to low and middle income Americans. Our government, on a federal, state and local level, has long recognized this basic fact and has encouraged the development of cooperative housing through a wide variety of housing programs. The I.R.S. has now jeopardized the financial stability of a good number of these housing cooperatives by misinterpreting Section 277 in a way that demands millions of dollars from housing cooperatives that are struggling to remain viable in a difficult real estate market.

In recent years, the I.R.S. has taken the position that interest income on reserve funds and revenue from laundry and parking facilities for the use of building residents should be subject to taxation under Section 277 - despite the fact that such housing cooperatives have no "net income" when the expenses of operating the cooperative are taken into account.

The I.R.S. position makes no sense. In fact, many of the cooperatives with large reserve funds are state-regulated low and middle income coops that by law must maintain large reserves for emergency repairs. According to state laws, the more repairs the housing coop needs, the larger the reserve that must be maintained for the anticipated expenses for repairs. In this situation, the I.R.S. would tax the interest on this reserve fund, despite the fact that this housing coop is actually in poor financial shape. A similar housing cooperative in good repair would maintain a minimal reserve fund and go untaxed.

A practical example of the inequitable burden caused by the I.R.S. position is represented by the plight of Trump Village, a 1,600 unit state-regulated housing cooperative in my congressional district in New York. To qualify for an apartment in Trump Village, a family must have an income below $20,000. 55% of the heads of household in Trump Village are over 60 years of age. Of this number, 75% are more than 75 years of age. The I.R.S. claims that under Section 277, Trump Village cooperators owe 3 million dollars through tax year 1986 alone. This is due to the fact that New York State Mitchell-Lama Housing regulations required Trump Village to build up a reserve fund in order to pay for the extensive repairs needed by the aging buildings. In order to pay this sum, Trump Village would have to double the carrying charges paid by residents. I don't know how many of the seniors and others living on limited incomes in Trump Village will be able to come up with that kind of money.

The I.R.S. position is even more inequitable when the original intent of Section 277 is considered. When Section 277 passed Congress in 1969, it was intended to apply to membership organizations like country clubs, which had a large amount of non-membership income which was going untaxed. Section 277 was properly intended to prevent country clubs from sheltering taxable income. However, in 1990, the I.R.S. decided that since housing cooperatives were technically membership organizations, they too should be subject to Section 277 - effectively deciding that housing coops should be treated like country clubs!

I urge the Subcommittee to act to pass legislation which will make very clear the fact that Section 277 does not apply to housing cooperatives and never was intended to apply to housing cooperatives. As such it is critical that any measure considered have an effective date which is retroactive. Only legislation which is retroactive will address the unfair burden the I.R.S. has placed on Trump Village and many other housing cooperatives. And only legislation which is retroactive will clearly demonstrate that this is not a measure intended to create a new tax break - it is a measure which will correct an I.R.S. misinterpretation of Section 277. Simply said, this legislation will demonstrate that Congress knows the difference between housing cooperatives and country clubs.

Chairman RANGEL. Well, let me thank you for the leadership that you provided in this area.

Generally speaking, the IRS frowns on retroactivity. Clearly where the intent of Congress was not to penalize homeowners, it would seem to me that if you are talking about equity and fairness, that it not only be prospective, but retroactive to remove the fears and the harms that have beset people whose major investment is in a co-op. The fact is this particular constituency is so important to a city that finds its tax base dwindling and many of these people are the anchors of our great cities.

So it is very important that you, I, and others work with the Chairman of the Senate Finance Committee, who is fully aware and cooperative with us in this effort. I hope that you and I can return home saying that we have removed this inequity and this fear that so many of our constituents have.

So let me thank you for your support and your leadership in this area.

Mr. SCHUMER. Thank you, Mr. Chairman. I appreciate it.

Chairman RANGEL. Mr. Hefley. Joel Hefley, Colorado. Congressman, you are delivering this statement from the lieutenant governor and the statement will be entered into the record.

You can give your testimony or you can read the statement or proceed in the manner that you feel most comfortable.

STATEMENT OF HON. C. MICHAEL CALLIHAN, LIEUTENANT GOVERNOR OF COLORADO; AND CHAIRMAN, AEROSPACE STATES ASSOCIATION, AS PRESENTED BY HON. JOEL HEFLEY, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF COLORADO

Mr. HEFLEY. Thank you, Mr. Chairman. I am pinch hitting today for the lieutenant governor of Colorado, Michael Callahan, who is also the chairman of the Aerospace States Association, and Lieutenant Governor Callahan who regrets that he can not personally be here today on a matter of great importance to our mutual constituents and to other interested persons across the United States.

On behalf of myself and Lieutenant Governor Callahan and the Aerospace States Association, and as Governor-appointed delegates from 33 States, we thank you and the committee for the opportunity to be here today to discuss the importance of tax-exempt status for spaceport bonds.

The Aerospace States Association works to retain and enhance employment opportunities in our domestic aerospace industry. I think today you will receive testimony from the States of Alaska, California, Florida and New Mexico. I think their interest in this subject is very obvious, but less immediately obvious, perhaps, are the interests of States such as Colorado, Alabama, Wisconsin, Arizona, Pennsylvania, Utah and Tennessee, States without a space launch capability and yet a very deep interest in this subject of space.

Our home State of Colorado is one example. We are home to a vast array of space infrastructure, including NORAD, the Air Force Space Command, the U.S. Space Grant Consortium and the U.S. Space Foundation, the National Oceanic and Atmospheric Administration and numerous others.

Some 80 percent of America's commercial launch vehicles are manufactured in part in Colorado by Martin Marietta and McDonnell Douglas. About 45 percent of our people are employed in aerospace and related high-tech fields, which is the largest segment of our manufacturing base. Without a strong modern and competitive American launch capability, it is fair to say that all of Colorado's space assets and the high-quality career building jobs they represent are threatened. This goes for many of these other States I mentioned as well.

In the post-Cold War environment, many of the traditional users of America's space program, such as the military, are downsizing. We look for growth in the commercial space sector to take up the slack. The commercial space transportation industry delivers privately owned and operated satellites and other cargo to and from space.

This industry depends on public spaceport infrastructure for its operation. The commercial space transportation industry is recognized by the Department of Transportation as an integral element of our Nation's comprehensive transportation system. As such, space transportation deserves equal treatment by the Federal Government for the development and maintenance of infrastructure required for its operation.

Providing tax-exempt status to spaceport bonds would give them treatment equal to seaport and airport bonds and to enable the continued commercialization of the space transportation industry.

In 1992, U.S. commercial launch vehicle sales reached $400 million. These launch vehicles serve, among others, the impressive U.S. commercial communication satellite industry which had $1 billion in sales in 1992. Commercial space operations in the face of increasing stiff international competition continue to show a positive trade balance.

Based on current Federal policies and law, including the Commercial Space Launch Act, the commercial launch industry is positioned to launch an increasing percentage of military and NASA payloads. State governments and private industry are ready to invest significant moneys in spaceport infrastructure development and improvements, but they require and deserve the same incentives that make investment in other transportation infrastructure attractive.

Presently Florida, California, Alaska, and New Mexico have existing or proposed spaceport sites. They will benefit directly from granting of tax-exempt status for bonds used to build or refurbish launch facilities, but equally important is the benefit to the nonlaunch States which also will be directly affected.

States like Colorado host industries involved in the manufacture, as I indicated earlier. That is why the Aerospace States Association at its June meeting here in Washington, D.C., unanimously passed a resolution in support of tax-exempt status for spaceport bonds and that is why we are giving testimony here today.

Tax-exempt status is an appropriate way and means to incentivize investment in our space infrastructure. It is in line with the Clinton administration call for public/private partnerships to stimulate economies at the State and local levels. It will send a positive message to the private sector here and serve notice to our

foreign competition, which is heavily subsidized, that America is ready to reclaim its preeminent position in space.

We can build our existing commercial launch infrastructure, which is badly outmoded, and construct new launch and recovery facilities with these funds. To be state of the art in space requires state of the art financing on the ground.

Tax-exempt spaceport bonds is a critically important first step. On behalf of its 33 member States, the Aerospace States Association respectfully urges the House Ways and Means Committee to support tax-exempt status for spaceport bonds.

I want to thank you again, Mr. Chairman, and members of the committee for letting me stand in for this group to try to get their message across to this important committee.

Chairman RANGEL. Thank you, Mr. Hefley.

[The prepared statement follows:]

STATEMENT OF
C. MICHAEL CALLIHAN
LIEUTENANT GOVERNOR OF COLORADO
CHAIRMAN, AEROSPACE STATES ASSOCIATION

Introduction by Rep. Joel Hefley

Mr. Chairman and Members of the Subcommittee, I am pleased to appear today on behalf of Michael Callihan, Lieutenant Governor of Colorado and Chairman of the Aerospace States Association. Lt. Governor Callihan regrets that he could not appear personally on the matter of great importance to our mutual constituents and other interested persons across the United States.

Statement

On behalf of myself, Lt. Governor Callihan, and the Aerospace States Association (ASA) and its governor-appointed delegates from 33 states, we thank you for the opportunity to address the Subcommittee on the importance of tax-exempt status for spaceport bonds.

The Aerospace States Association works to retain and enhance employment opportunities in our domestic aerospace industry and supports educational initiatives in the fields of math and science. We view the aerospace sector as a key element of our industrial base and as a crucial component in this country's competitive posture in the global marketplace. Furthermore, it is the arena where the brightest engineering students at our universities will find employment and build quality careers in service to their communities and their country.

Today, you will receive testimony from the states of Alaska, California, Florida, and New Mexico, states whose interest in this legislation will be obvious to you. Less immediately obvious, perhaps, are the interests of states such as Colorado, Alabama, Wisconsin, Arizona, Pennsylvania, Utah and Tennessee, states without space launch capability.

Our home state of Colorado is one example. We are home to a vast array of space infrastructure, including NORAD, Air Force Space Command, the Colorado Space Grant Consortium, the U.S. Space Foundation, NOAA, and numerous others. Some eighty (80%) percent of America's commercial launch vehicles are manufactured in part in Colorado by Martin Marietta and McDonnel Douglas. Fully five (5%) percent of our people are employed in aerospace and related high-tech fields, the largest segment of our manufacturing base.

Without a strong, modern and competitive American launch capability, it is fair to say that all of Colorado's space assets and the high quality, career building jobs they represent are threatened.

In the post Cold War environment, many of the traditional users of America's space program, such as the military, are downsizing. We look for growth in the commercial space sector to take up the slack. The commercial space transportation industry delivers privately owned and operated satellites and other cargo to and from space. This industry depends on public spaceport infrastructure for its operation.

The commercial space transportation industry is recognized by the Department of Transportation as an integral element of our nation's comprehensive transportation system. As such, space transportation deserves equal treatment by the Federal Government for the development and maintenance of infrastructure required for its operation. Providing tax-exempt status to spaceport bonds would give them treatment equal to seaport and airport bonds, and would enable the continued commercialization of the space transportation industry.

In 1992, U.S. commercial launch vehicle sales reached $400 million. These launch vehicles serve among others the impressive U.S. commercial communications satellite industry, which had $1 billion in sales in 1992. Commercial space operations, in the face of increasingly stiff international competition, continue to show a positive trade balance.

Based on current Federal policies and law (including the Commercial Space Launch Act), the commercial launch industry is positioned to launch an increasing percentage of military and NASA payloads. State governments and private industry are ready to invest significant monies in spaceport infrastructure development and improvements, but they require and deserve the same incentives that make investment in other transportation infrastructure attractive.

Presently, Florida, California, Alaska and New Mexico have existing or proposed spaceport sites and they will benefit directly from the granting of tax exempt status for bonds used to build or refurbish launch facilities. But equally important is the benefit to the non-launch states, which also will be directly affected. States like Colorado host industries involved in the manufacture and testing of launch vehicles and their components, or the manufacture of satellites and other payloads. Without a strong U.S. launch industry, these states would experience a significant loss of industry and jobs.

That is why the Aerospace States Association, at its June meeting here in Washington, D.C., unanimously passed a resolution in support of tax exempt status for spaceport bonds. And that is why we are giving testimony here today.

Tax exempt status is an appropriate way and means to incentivise investment in our space infrastructure. It is in line with the Clinton Administration call for public-private partnerships to stimulate economies at the state and local levels. It will send a positive message to the private sector here and serve notice to our foreign competition, which is heavily subsidized, that America is ready to reclaim its preeminent position in space.

We can rebuild our existing commercial launch infrastructure, which is badly outmoded, and construct new launch and recovery facilities with these funds. To be state of the art in space requires state of the art financing on the ground. Tax exempt spaceport bonds is a critically important first step.

On behalf of its 33 member states, the Aerospace States Association respectfully urges the House Ways and Means Committee to support tax exempt status for spaceport bonds.

Thank you again for the chance to share our views on this subject.

Chairman RANGEL. Are you saying that the group and you believe that the spaceport or the launch industry is being unfairly treated by our current tax policy?

Mr. HEFLEY. Well, yes, Mr. Chairman. We have tax-exempt airport bonds. We have tax-exempt seaport bonds. We don't have tax-exempt bonds for the space launch industry, partially because the commercial space launch industry is a very new industry, even though we have been in space for quite a number of years.

I was talking to a group just the other day that was talking about putting up a satellite and they are going to have it launched by Guatemala. It is a company in this country, but they are going to Guatemala to get the launch done. I don't think we want that.

I think we would like those jobs and that launch capability here in the United States, but in order to get that, we are—I think we are going to have to give them incentives.

Chairman RANGEL. And the case can be made that the industry actually needs this incentive and it is not just something that we are giving politically to one industry or one part of the country.

Mr. HEFLEY. No, I think that is absolutely——

Chairman RANGEL. I mean, can it be proven that we are not competitive unless we are able to give a little help to this young industry?

Mr. HEFLEY. Yes, Mr. Chairman, I believe it can.

Chairman RANGEL. Mr. Hancock.

Mr. HANCOCK. Thank you. I just have one question on this. When you mention the seaport and airport bonds, are these normally governmental operations? Are the seaports and airports, in other words, owned by the government with the tax-exempt bonds?

Mr. HEFLEY. Well, yes, these are tax-exempt bonds.

Mr. HANCOCK. I know they are tax-exempt bonds, but the spaceports, is that a private sector operation or is it government locations that we are talking about here?

Mr. HEFLEY. I think it could probably be any. So far it has been government, but I think it could be private, yes.

Mr. HANCOCK. I think if you want to do it for government, you ought to be willing to do it for the private sector. They do it anyway.

Thank you.

Chairman RANGEL. Mr. Kopetski.

Mr. KOPETSKI. Thank you, Mr. Chairman.

Mr. Hefley, just two quick questions. One, do you know the cost impact of this provision?

Mr. HEFLEY. I am sorry, I don't, Mr. Kopetski. I don't know.

Mr. KOPETSKI. Do you have a funding source for it to replace the revenue?

Mr. HEFLEY. No, I do not have a funding source to replace the revenue. The point is we are getting no revenue at the present time, so it is not matter that we are taking revenue that is already existing. We would be taking, I shall suppose, theoretical revenue, but I think it is theoretical because I don't think we can get that revenue anyway because these spaceports won't be built.

Mr. KOPETSKI. You are saying no bonds will be issued unless the industry gets this exemption.

Mr. HEFLEY. I believe that is the case. Yes, I do.

Mr. KOPETSKI. Thank you.

Thank you, Mr. Chairman.

Chairman RANGEL. Thanks so much, Congressman.

Congressman Ted Strickland, Ohio. We welcome your testimony and contribution. Your entire statement will be entered into the record without objection.

STATEMENT OF HON. TED STRICKLAND, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF OHIO

Mr. STRICKLAND. Thank you, Mr. Chairman and members of the subcommittee for allowing me to testify before you today.

I have a written testimony which I will not read, but I would like to take just a few moments to highlight and summarize what I would like to communicate to you. H.R. 2111, which I introduced on May 12, 1993, would create new private sector jobs. It would do so by adjusting the current capital limitation in the small issue industrial development bond program from $10 million to $20 million.

My bill is national in scope, but the need to adjust the cap was underscored by a startup company in my district which purchased an idle factory in a small town that was experiencing 8.5 percent unemployment. I am sure many Members of this subcommittee have similar idle factories located in their districts as well.

This particular facility was purchased and renovated with IDBs, a total of $9.2 billion, representing roughly a 2 to 1 match between tax-exempt bonds and private capital. Now, this business literally "took off." It doubled its employment in the first quarter and grew by 500 percent in the first year. New jobs went from 73 to 445. The business is ready to create still more jobs, but has run into a problem with the capital limitation cap.

Under the existing tax law, the maximum that can be put into any IDB financed facility within 3 years before or after its opening is $10 million. That includes both private capital as well as IDBs. Since this business has already spent almost $10 million to open, the capital limitation prevents it from simply spending additional private capital to expand the factory, buy new machinery, and create still more jobs.

The capital limitations are designed to encourage IDBs for small- to medium-sized projects, and not merely as "icing on the cake" of huge projects that would be funded through private capital sources anyway. Now, while I support the theory behind the capital limitation, it has not been adjusted since 1978, and I believe it is time to do so.

My bill would accomplish that goal in a responsible fashion. It would raise the cap to a total of $20 million, but the additional $10 million would have to come from private capital sources, sources that would be fully taxable. It would allow those additional private capital sources to be spent only after the project was up and functioning. And it would not alter the existing State by State caps.

This proposal has already been supported by the House of Representatives. In 1992 the provision was passed by the Senate as part of H.R. 11 and it was adopted by the House and Senate conferees. Unfortunately, as you know, President Bush vetoed that measure.

I urge the Ways and Means Committee to approve this change once again, either as part of the pending conference on reconciliation, which contains an extension of the IDB program, or in subsequent tax legislation reported by the committee.

Thank you, Mr. Chairman.

Chairman RANGEL. Thank you.

[The prepared statement follows:]

TESTIMONY OF THE

HONORABLE TED STRICKLAND OF OHIO

BEFORE THE SELECT REVENUE MEASURES SUBCOMMITTEE

OF THE

HOUSE WAYS AND MEANS COMMITTEE

ON

H.R. 2111

July 13, 1993

Mr. Chairman, Members of the Subcommittee, I appreciate the opportunity to appear before you today in support of H.R. 2111, legislation which I introduced on May 12, 1993. My bill has been referred to the Ways and Means Committee, and I strongly urge you to adopt it as a means of creating new jobs and opportunities in the private sector of our economy.

My bill would adjust the current capital limitation on small issue industrial development bonds (IDBs) from $10 million to $20 million so as to allow more private capital to be used in the financing of IDB projects. This modest adjustment in the IDB capital cap will help create permanent private sector jobs in our economy while at the same time preserving, and actually expanding, the amount of private capital used in IDB-financed projects.

My bill is national in scope, Mr. Chairman, but the need to adjust the current IDB capital limitation cap was brought to my attention when an employer in my District faced a "problem" -- they were wildly successful in using IDBs to stimulate new jobs and growth.

This company purchased an idle factory facility in a town in my District where the unemployment rate was 8.5%. The company used a total of $9.2 million in Ohio Enterprise (IDB) bonds. Of this amount, $6.5 million were public bonds and $2.7 million came from private capital sources. When the factory reopened in January of 1992, it employed 73 workers. Two months later, employment at the factory more than doubled to 193 workers. After two other expansions, a total of 445 workers were employed at this facility by February of this year.

At that point, the facility found itself at capacity and could not expand further without spending additional capital for building and equipment. This employer was ready and willing immediately to spend its private capital to expand the factory, Mr. Chairman. In doing so, it would create additional jobs -- more than the 445 already created in just one year of operation. Unfortunately, that is where the capital limitation tax cap came into play, making such an immediate, straightforward expansion difficult, if not almost impossible.

The tax code includes in Section 144(a)(4)(A) a limitation on capital expenditures used in IDB financing. The limitation is currently set at $10 million for all capital expenditure used -- whether it be public expenditures financed through bonds or private capital used in conjunction with such bonds. This limitation, which has not been adjusted since 1978, was designed to apply to all expenditures made three years before, as well as three years after, the initial bond offering.

This capital limitation prevented this successful company in my District from simply putting additional private capital into expanding the facility and creating new jobs. Any alternative available is a convoluted and complicated one which does not make the most efficient use of capital resources.

As I understand, the capital expenditure limit is designed to prevent the use of IDBs as mere "icing on the cake" on much larger, conventionally-financed projects. By initially restricting the size of any project financed by IDBs, Congress wanted to insure that only small to medium sized projects would receive IDB financing. This is a goal I support, Mr. Chairman, but the current capital limitation works to penalize unfairly IDB-financed businesses that are successful. A company which wants to put its own money into expanding jobs and opportunity in a community should not be delayed from doing so. I firmly believe it is now time to adjust the operation of the capital limitation cap.

My bill, H.R. 2111, would do so in a responsible and targeted fashion, Mr. Chairman. It would raise the cap for private capital by an additional $10 million to a total of $20 million. My bill would not change the maximum amount of public funds allowed in each IDB project -- no more than $10 million per project. The additional $10 million in private capital would also apply to expenditures made after the original bond offering, in order to insure the funds were available for expansion purposes only. The additional private capital would, of course, be taxable to the U.S. Treasury. Finally, my bill would not alter the existing total bond activity caps set on a state-by-state basis.

If adopted, my bill would simply allow successful IDB-financed projects to continue to grow and produce jobs without being artificially limited by the current $10 million cap on capital expenditures.

This job-expansion concept is not radical, Mr. Chairman. This proposal was passed last year by the other body as part of H.R. 11, and was adopted by the Conferees of this Committee as a means of aiding distressed economic areas. Unfortunately, as you know Mr. Chairman, President Bush vetoed the bill, and thus this provision did not become law.

At the time it was considered last year, the Joint Tax Committee assigned this provision a small revenue loss of $21 million over five years. On April 29th of this year, I requested an updated estimate from Mr. Gutman. While not final, I understand that the Joint Committee has informed Senator Glenn's office that last year's estimate is still a good working number.

I strongly urge the Ways and Means Committee to adopt this proposal again, Mr. Chairman, either as part of the pending Conference on H.R. 2264, or as part of any supplemental bill or bills to be reported from this Committee. It is a modest, but important, way to use a public-private partnership to encourage the creation of permanent private sector jobs with taxable private sector money.

I look forward to working with you, Mr. Chairman, and the Members of the Subcommittee, to enact this reform bill.

Chairman RANGEL. Mr. Kopetski.

Mr. KOPETSKI. No questions.

Chairman RANGEL. Does your legislation restrict the removal of the cap only in distressed economic areas?

Mr. STRICKLAND. No, sir, it does not. It would be generally applicable.

Chairman RANGEL. Do you know by removing the present cap and substituting your language how much this would cost?

Mr. STRICKLAND. We have asked for an estimate from the Joint Tax Committee. Last year they estimated that at $21 million over a 5-year period of time. We have asked for updated information and have been told that that $21 million is certainly near what any updated figure would be, although they haven't done a final analysis.

Chairman RANGEL. Could you state what support you have for this legislation? Are there other Members that have signed onto this?

Mr. STRICKLAND. Yes. Quite frankly I have not sought cosponsors at this point. I will proceed to do that. But the Governor of Ohio and other entities have expressed interest. I know of no opposition to the proposal that I have been able to identify.

Chairman RANGEL. Well, it will be helpful to the committee to know what support in a very positive way we have for this since it doesn't really cost that much, but we will have to weigh whether or not this is an isolated case in your hometown, or whether this is a national problem that we can correct to create more jobs.

Mr. STRICKLAND. Sure.

Mr. Chairman, the impact of H.R. 2111 will be national in scope. Mr. Coyne, Mr. Matsui, and Mr. Kopetski have signed on as cosponsors of this bill. In addition, this bill is strongly supported by the Council of Development Finance Agencies, which represents over 100 State and local government finance agencies in 38 States, has submitted testimony to that effect.

Chairman RANGEL. Thank you.

We will go now to panel two. And from my home down is Commissioner Aponte here, one of our outstanding public servants from the State of New York representing the National Council of State Housing Agencies. He is the commissioner of the New York State Division of Housing and Community Renewal.

Also on this panel is the Association of Local Housing Finance Agencies. It will be represented by Stephen Leeper, who is the treasurer and also director of the Housing Urban Redevelopment Authority of Pittsburgh.

We also have the National Association of Home Builders. We have Mr. Peace, who will be representing the president, J. Roger Glunt, and on this panel will be the Council for Rural Housing and Development. Pamela Borton is the chairperson and past president, and she will testify. She is also the president of the Southwind Management Services in Clearwater, Fla.

All of the witnesses by unanimous consent will have their full statement entered into the record. You may proceed by reading it, or by highlighting it, or by giving information or testimony in addition to it. We will start with Commissioner Aponte. We welcome

you to the Ways and Means Committee and, as a New Yorker, we thank you for the great job you are doing for our State.

STATEMENT OF ANGELO J. APONTE, COMMISSIONER, NEW YORK STATE DIVISION OF HOUSING AND COMMUNITY RENEWAL, ON BEHALF OF NATIONAL COUNCIL OF STATE HOUSING AGENCIES

Mr. APONTE. Thank you very much, Mr. Chairman. To speed up a little bit, I will highlight some of the important portions of my full testimony.

I would like to thank you for this opportunity to testify in enthusiastic support of proposals to amend the mortgage revenue bond and the low-income housing tax credit programs to make them better able to address the housing needs of lower income families and to respond to testimony on those issues offered by the Treasury.

As you know, I am Angelo Aponte, director of housing for the State of New York, and I am testifying this morning on behalf of the National Council of State Housing Agencies whose members are the State housing finance agencies which finance affordable housing in the entire country.

HFAs have issued over $74 billion in MRBs to finance the home purchases of more than 1.5 million low- and moderate-income families and $26.8 billion in bonds to finance over 500,000 rental apartments for such families.

NCSHA's members also allocate the tax credit in every state, helping to finance since 1987 over 500,000 apartments for families with incomes at 60 percent or less of their area's median income. NCSHA is the principal collector and repository of data under the tax credit program, sharing this data with Congress, HUD, the Treasury, and the public, and we greatly appreciate the Ways and Means Committee's efforts to make the MRB and tax credit programs permanent. Both programs have virtually been shut down since their authorization expired on June 30, 1992, over 1 year ago.

We thank you also for including permanent MRB and tax credit extensions in the House-passed budget reconciliation bill. The Senate bill, however, provides a permanent tax credit extension and an MRB extension of less than 12 months through next June. Though described as a 24-month extension, 12 months are retroactive, a meaningless provision for most States.

That brief extension effectively assures another jarring, lengthy and potentially lethal disruption of the MRB program because Congress will not pass another tax bill by next July and may not consider one at all next year.

MRBs provide mortgages to more than 130,000 lower income, first-time home buyers every year and account for one of every 12 mortgages made to first-time buyers and most of the mortgages for buyers at the bottom of the home ownership ladder who need the most help.

In the last decade, MRBs have been extended seven times and now is the time to make this proven program permanent. I am submitting the full text of my testimony for the record, but I would like to highlight the importance of two programmatic issues that have been submitted to the subcommittee.

First, as to the MRB extension. In New York, we have employed MRBs for affordable housing through the State's mortgage insurance agency, SONYMA, to benefit first-time home buyers to the extent of $3 billion, assisting more than 49,000 families in being able to achieve their dream of home ownership.

The program works, has been highly effective and needs to be permanently extended. But one of the restrictions of the program is very counterproductive and makes little sense. I am speaking of the present restriction requiring that a two- to four-family home be occupied by the owner and the residence be occupied for at least 5 years prior to the execution of the mortgage.

In New York, Herculean efforts are being made to reclaim vast neighborhoods. Brownsville in Brooklyn, Melrose and Claremont in the Bronx, and Bradhurst in Harlem are vivid examples where working class families are trying to reclaim the neighborhoods which have suffered devastation in the past.

The model best suited for this situation is a two-family residence where the income from the rental unit justifies the debt service capability of the owner.

Employees of my own agency earning about 60 percent of median income have struggled to move out of public housing projects and to buy one of these townhouses or two-family units. Instead they found themselves ineligible for the favorable rates and programs offered under a SONYMA mortgage solely for the reason that their intended purchase was newly constructed.

These aspirants to the American dream of home ownership are precisely the people for whom MRBs are intended and we should remove this barrier.

Second, tax credits should also be made permanent to protect the stability of the market for production of affordable housing. Unlike some other areas of the country, in New York we cannot produce stand-alone tax credit projects. We must couple tax credits with other public subsidies to make feasible projects where typically a family earning only 60 percent of median income or less can barely meet the current maintenance and operating expenses of the unit.

With all of the long lead time elements of any real estate project and the social and political issues of siting low-income housing, the pipeline for development of these projects needs to have the security of knowing that a key element in the financing plan will be there at the end of the road.

New York has, since the early 1980s, dedicated more than $7 billion to direct capital subsidy of these types of low-income housing programs and given the long-term nature of housing capital and the constant realities of State budget imperatives, however, borrowing for such programs is a fact of life. When the State issues debt to finance the balance of the capital costs of a project after using the tax-credit syndication proceeds, the State pays the interest.

To maximize the value of the tax credits, taxable financing is now employed, with the result that the State's limited resources are available to produce fewer units of housing. We are proud that from the program's inception in 1987 we have used every single available dollar of allocated tax credit, both from the original allocation and the subsequent national pool, and we agree with the

Treasury that careful scrutiny and underwriting of each project must be done to assure that none of these precious subsidy dollars are wasted.

We underwrite every project with great care and attention to detail and at each of the mandated three underwritings, we stretch the development budget to keep it as lean as possible so the next project can be built. Perhaps the Treasury is looking at the process from their end of the telescope, but layering review and concern about oversubsidization is precisely what we do all the time.

The methodology that the State uses to come up with the rest of the necessary capital should not be restricted by precluding the use of up to the full 70 percent credit in combination with the tax-exempt bonds.

In a similar case, when the issue of matching obligation was raised in the context of the HOME program, an opinion was obtained from HUD that the New York program of issuing score bonds would not disqualify the match. HUD recognized that how my State met its obligations was an internal matter and did not affect the intent of the program, and I believe that the same principles should apply here.

Thank you.

[The prepared statement follows:]

Testimony in Support of Amendments to the Mortgage Revenue Bond and Low Income Housing Tax Credit Programs

July 13, 1993
Subcommittee on Select Revenue Measures
House Committee on Ways and Means

Angelo J. Aponte, Commissioner
New York State Division of Housing and Community Renewal
on behalf of the
National Council of State Housing Agencies

Enact Amendments to Make the MRB and Tax Credit Programs More Effective

Mr. Chairman, Representative Hancock (R-MO), and members of the Subcommittee, thank you for this opportunity to testify in enthusiastic support of proposals to amend the Mortgage Revenue Bond (MRB) and Low Income Housing Tax Credit (Tax Credit) programs to make them better able to address the housing needs of lower income families.

We greatly appreciate the efforts of the Ways and Means Committee to make the MRB and Tax Credit programs permanent. Both programs have been virtually shut down since their authorization expired June 30, 1992, over one year ago. Each passing month, production of nearly 10,000 low income apartments is lost or delayed, and thousands of low income families lose the chance to rent or own safe and affordable housing. Thousands of jobs and millions of dollars in tax revenues, wages, and other economic activity generated by these programs are draining away.

Thank you for including permanent MRB and Tax Credit extensions in the House-passed Budget Reconciliation Bill. The Senate bill, however, provides a permanent Tax Credit extension, but less than a 12-month MRB extension, through next June. (Though described as a 24-month extension, 12 months are retroactive, a meaningless provision for most states.) That brief extension effectively assures another jarring, lengthy, and potentially lethal disruption of the MRB program, because Congress will not pass another tax bill by next July and may not consider one at all next year.

In floor action on the budget reconciliation bill, however, the Senate spoke strongly and unanimously in favor of a permanent MRB program when it adopted a "Sense of the Senate" resolution urging the acceptance of a permanent MRB extension in conference. Since then, over 50 senators -- Democrats and Republicans -- have signed a letter to Chairman Moynihan and the other Senate conferees urging them to support a permanent MRB extension in conference.

The MRB program deserves a permanent extension. It is the most heavily cosponsored legislation in either house. An unprecedented 90 percent of the 102nd Congress (490 Representatives and Senators) cosponsored legislation to make MRBs permanent. Identical legislation introduced in the 103rd Congress has captured the support of a majority of both houses and their tax committees in less than five months.

According to the Joint Tax Committee's estimates, the Senate bill already invests $550 million for the practical one-year MRB extension. The Joint Committee estimates that a permanent MRB

extension would cost only about $350 million more than the short-term extension included in the Senate bill. If Congress accepts a one-year extension of the MRB program with an intention to renew it again next year, it will be misrepresenting its actual cost in this bill which is supposed to set fiscal policy for another five years.

MRBs provide mortgages to more than 130,000 lower-income first-time homebuyers every year, and account for one of every twelve mortgages made to first-time buyers and most of the mortgages for buyers at the bottom of the homeownership ladder who need the most help. The National Council of State Housing Agencies (NCSHA) reports that MRB homebuyer incomes in 1992 averaged $28,500, less than 74 percent of the national median, compared to $42,300 for the average conventional first-time homebuyer and $49,800 for all conventional homebuyers. The average purchase price of an MRB home was $64,270, compared to $100,200 for first-time conventional homes and $131,300 for all conventional homes.

The new homes financed with MRB loans in 1992 produced 27,000 jobs and generated over $750 million in wages and tax revenues. The National Association of Home Builders estimates that if MRBs are not extended, as many as 37,000 jobs will be lost in 1993 and 63,000 each year thereafter.

In the last decade, MRBs have been extended seven times. Now is the time to make this proven program permanent. We strongly urge you to hold firm and insist on the permanent MRB extension that you passed, the President has asked for, and the Congress adopted in the vetoed urban aid tax bill last fall.

I am Angelo J. Aponte, Commissioner of the New York State Division of Housing and Community Renewal. I am testifying this morning on behalf of NCSHA. NCSHA's members are state-chartered, housing finance institutions which finance affordable housing in 48 states, the District of Columbia, Puerto Rico, and the Virgin Islands. State Housing Finance Agencies (HFAs) have issued over $74 billion in MRBs to finance the home purchases of more than 1.5 million lower income families. HFAs have also issued $26.3 billion in bonds to finance over 500,000 rental apartments for such families.

NCSHA's member state housing agencies also allocate the Tax Credit in every state, and the U.S. territories. Since 1987, these agencies have helped finance over 500,000 apartments for families with incomes at 60 percent or less of their area's median income using the Tax Credit. NCSHA is the principal collector and repository of data on the Tax Credit program, gathering information from its member agencies through annual surveys and sharing this data with Congress, HUD, the Treasury, and the public.

In 34 states, HFAs administer nearly $500 million in new federal HOME Investment Partnership (HOME) funds to support a wide range of affordable housing programs for families who earn 80 percent or less of their area's median income. HFAs collectively administer more than 600 affordable housing programs ranging from homeless to homeownership initiatives.

Refinements to the MRB Program Should be Considered

Making the MRB program permanent is NCSHA's first priority. However, there are aspects of the MRB program that raise rates paid by MRB homebuyers and restrict low income families from participating in the program without any compensating gain to the federal government. Congress should consider these issues in connection with the budget reconciliation process.

Permit MRB Financing of Two-Family Newly Constructed Homes

MRB financing for two to four family residences is currently permitted if one of the units is occupied by the owner and the residence was occupied at least five years prior to execution of the mortgage. This precludes the financing of two to four family newly constructed homes.

Duplex homes are common in many older cities where scarce land, high construction costs, and high property values make multi-unit homes a more cost effective choice for lower income families. In addition, duplexes are an important low-cost option in poor rural areas. We recommend that the MRB program be amended to permit MRB financing for the purchase of newly constructed two-family homes.

The State of New York Mortgage Agency (SONYMA) has reviewed its data on all MRB mortgages on existing two-family homes financed in the downstate New York area for the past three years. SONYMA found that the average purchase price of a two-family home was only 20 percent greater than that of single family homes in the same areas, while the incomes of two-family home purchasers were, on average, five percent less than single family homebuyers. SONYMA's data supports the assertion that two family homes are more economical per family housed and that the rental income from the second unit is taken into consideration when the bank underwrites the mortgage. Without that additional income, these families could not afford to purchase their own home even with MRB financing.

We believe that the income earned by the MRB borrower and the rental unit tenants is modest and necessary to support the mortgage. However, if the Committee requires further assurance that such borrowers are not earning windfall profits, the amendment could be structured to allow MRB financing of new two-family homes only in targeted areas or enterprise zones. Targeted areas are census tracts in which 70 percent or more of the families are classified as low income (below 80 percent of area median income). It is likely that renters in these areas would have incomes well below the MRB program limit which would not support rents that result in a windfall to the MRB borrower.

In New York City alone, the New York Housing Partnership has sponsored the development of over 1,000 new two-family homes. These homes will be lost to lower income families unless they can be financed with MRBs.

In recent testimony before the Subcommittee, the Treasury withheld support for this amendment, stating that, "residential projects with more than one dwelling should be subject to the rules and subsidy programs designed for multifamily housing." MRB financing is permitted under current law for existing one to four family houses. We believe that extending this treatment to newly constructed homes is consistent with current law and beneficial because it will provide both ownership opportunities for lower income families and affordable rental housing in a cost-efficient manner. Financing two-unit rental housing with multifamily bonds would not provide the homeownership opportunity for lower income families that this provision would provide.

Increase the Limit on MRB-Financed Home Improvement Loans

The current limit of $15,000 imposed in 1981 on MRB home improvement loans no longer reflects today's cost of undertaking home improvements. Since 1981, the U.S. Department of Commerce estimates that the cost of residential rehabilitation has increased approximately 31 percent. Recognizing that its own limit was too low, the Federal Housing Administration (FHA) raised the maximum on its Title I insured home improvement loans from $17,500 to $25,000.

The MRB home improvement loan limit should be raised at least to the new FHA limit of $25,000, adjusted upwards for two to four family homes, and indexed for inflation in the future. MRB home improvement loans help lower income families maintain their homes and preserve the existing housing stock. These loans are limited by law to upgrades in the basic livability, utility, or energy efficiency of the property.

The Treasury withheld support for this provision because it believes that such a change should be considered in the context of a general review of the program. As this Subcommittee is aware, the Congress has regularly reviewed the MRB program and has made significant adjustments to it over the past decade. In its most recent review last year, the Congress determined to make the MRB program permanent but was not able to act on programmatic changes in the context of the urban aid tax bill that carried its permanent extension. This and the other changes we have recommended should not be delayed any longer. We urge you to include them in the Budget Reconciliation bill.

Adjustment in Private Activity Volume Cap

Congress should consider the growing restraints the private activity cap imposes on the MRB program. The present state-by-state volume cap on the issuance of private activity bonds, including MRBs, is the greater of $50 per capita or $150 million annually. This cap was imposed in 1988 and has not been adjusted for inflation since, making it worth 20 percent less in 1993 dollars. Many states, including those where the majority of Americans actually live, exhaust their cap every year and still barely begin to meet the many needs, including housing, which compete for it.

NCSHA proposes at a minimum that the cap be expanded at least enough to account for inflation over the last five years and be indexed for inflation in future years.

Although not included in the list of proposals before the Subcommittee at this time, the following MRB programmatic changes were passed by Congress last year but are not included in either the House or Senate budget reconciliation bill this year. We urge the Subcommittee to request their consideration in conference.

Extend First-time Buyer Status to Holders of "Contracts for Deed"

The three-year rule (first-time homebuyer rule) should not be applied to very low income families (annual incomes below 50 percent of median indexed for inflation) who have previously purchased land under a "contract of deed." A contract of deed is a seller-financed contract for the sale of land under which legal title does not pass to the buyer until the final payment is made and for which the penalty for nonpayment is forfeiture of the land rather than judicial foreclosure. The amendment should also allow these very low income families to refinance the land costs in the MRB mortgage.

Clarify Treatment of Resale Price Control and Subsidy Lien Programs

Both state and local HFAs administer programs in which agency and other state and local funds are used to further reduce the cost of an MRB mortgage (for example, second mortgages to finance closing costs). An amendment is necessary to clarify that subordinate mortgage loans or grants used to finance downpayment and closing cost assistance do not constitute an ownership interest on the part of the lien-holder, the state or local government which made them.

Refinements to the Tax Credit Program Should be Considered

The success of the Tax Credit is due in large part to the important improvements Congress has made to the program since 1987. NCSHA's members are grateful to have had the opportunity to help this Committee design these changes. These improvements, along with fine-tuning by HFAs of their Tax Credit programs and increased competition among developers for Tax Credits, have resulted in a more efficient program which is increasingly responsive to the priority low income housing needs of the states.

HFAs have effectively implemented the Congressional mandate in the 1989 Tax Act to evaluate proposed projects to assure that each receives the minimum amount of Tax Credit needed for feasibility and long-term viability as a low income housing development. This evaluation considers all sources and amounts of financing, including other federal, state, or local subsidies and syndication proceeds. State allocation plans ensure that the Tax Credit is allocated in accordance with states' priority housing needs. In addition, HFAs now monitor Tax Credit projects for compliance with the program's low income occupancy requirements.

As with MRBs, a permanent Tax Credit extension must be our first priority. However, there are some program changes that the Subcommittee should consider.

Adjust the Carryforward Rule So It Works As Congress Intended

Each state receives an annual Tax Credit allocation of $1.25 per resident ("per capita" credits). In the 1990 Tax Act, states were given the authority to carry forward their unused per capita and returned (reallocated to the state from projects that do not go forward) Tax Credits for allocation in the next calendar year. Any Tax Credits carried forward but not used by the end of the second year are lost to the national pool and redistributed to qualified states. Qualified states are those which use all their available credit in the prior year. Before the carryforward provision was enacted, states were required to use all per capita and returned credits within the calendar year or lose them. There was no national pool.

The purpose of the carryforward change was to give states 24 months to allocate their per capita and returned Tax Credits and remove the "use it or lose it" pressure states felt at year-end. However, due to the way the provision was drafted, states must use all of their per capita and returned Tax Credits before they can allocate carryforward or pool credits. The provision of the 1990 Act which requires this ordering of Tax Credit allocation is commonly referred to as the "stacking rule."

The practical effect of the stacking rule is that states must allocate an amount equivalent to their combined per capita and returned credits to avoid the loss of carryforward credits to the national pool or pool credits from the program altogether. If a state

allocates less than the sum of its per capita and returned credits, its carryforward to the next year would be reduced by the difference between that amount and the total allocated. To avoid this loss of credit, states must allocate all of their per capita and returned credits and thus forfeit the opportunity to carry forward unused per capita and returned credits for one year as Congress intended. This effectively creates an every-other-year carryforward and does not give states the full 24 months to allocate their per capita and returned credits that Congress intended. The Tax Credit should be amended to allow states to allocate their carryforward or pool credits first.

Last year, Congress recognized that the stacking rule does not work when it effectively reversed it, with the Treasury's support, in tax legislation vetoed by the President. Because the stacking rule was not corrected last year, 28 states lost over $41 million in Tax Credits, $23 million of which were lost permanently from the program. This serious situation only underscores that the stacking rule does not work.

We are somewhat confused by Treasury's apparent reversal of its position on this issue. The Treasury incorrectly asserted in its testimony before the Subcommittee that the proposed stacking rule change would significantly reduce the flow of credit to the national pool and allow for an unlimited carryover of unused authority. This provision would amend the law to reflect Congress' original intent that a state be allowed to carry over an amount up to its annual allocation for an additional 12 months. Although a reduced national pool is likely in the first year after such a provision is enacted, the provision does not change the relative demand for credit authority among states and therefore will not effect the pool distribution significantly in the long term.

We ask you again this year to amend the Tax Credit program to allow states 24 months to allocate per capita and returned credits as Congress intended when it authorized the carryforward provision in the 1990 Tax Act.

Permit Use of the 70 Percent Credit With Tax-Exempt Bond Proceeds

We are grateful to the House, and you especially Mr. Chairman, for including a provision in the House-passed Reconciliation bill that would allow the use of up to the full Tax Credit with proceeds of the HOME program, a federal housing block grant to states and localities. We urge you to hold that position in conference with the Senate and to expand that provision to include tax-exempt bond proceeds.

Under current law, Tax Credit projects utilizing tax-exempt bond proceeds are limited to the 30 percent, rather than the 70 percent, present value credit. This limit was included in the original Tax Credit statute before states were required by the 1990 Tax Act to underwrite Tax Credit projects to ensure that they receive only the amount of subsidy necessary to their feasibility and long-term viability. States should now be allowed to determine the appropriate amount of credit to allocate with tax-exempt bonds through proven underwriting practices just as they make this determination for other projects.

There is no basis for Treasury's assertion that the combination of these subsidies could lead to oversubsidization of housing projects. In fact, Congress demonstrated its confidence in the states' ability to control against oversubsidization through sound underwriting when last year it delegated to them responsibility for conducting the HUD subsidy layering review process for Tax Credit projects which receive HUD subsidies.

The ability to use Tax Credits with tax-exempt bond proceeds is particularly important today because of the "credit crunch." Developers, both nonprofit and for profit, are finding it increasingly difficult to secure mortgage financing for Tax Credit projects. Use of up to the full Tax Credit in combination with tax-exempt bond financed mortgages and other federal subsidies can help alleviate this problem.

Allow for *de minimis* Exception for National Pool Qualification

States may not qualify for allocations from the national pool of unused Tax Credits unless they exhaust all of their available credit in the preceding year. However, undetected accounting errors, credits returned very late in the year, or amounts of credit too small to allocate to a project could prevent a state from participating in the pool despite their best efforts to allocate all of their available credit. The Treasury should be authorized to grant national pool qualification to states which do not allocate a de minimis amount of their total credit. Although the proposal before the Subcommittee does not define what would constitute a de minimis amount, we would be pleased to work with the Subcommittee and Treasury to make such a determination.

Prohibit Discrimination Against Subsidy Holders

To ensure that prospective tenants holding Section 8 subsidies are not refused units in privately-owned low income housing projects, most federal housing programs carry a prohibition on discrimination against certificate and voucher holders. The Tax Credit program should be amended to prohibit discrimination against holders of rental subsidies.

Implement Fair Housing Requirements

Some have questioned whether Tax Credit projects are housing minority tenants. We have no data that suggests they are not. However, we believe that Tax Credit projects should be subject to the same fair housing requirements as other assisted housing.

The Tax Credit program should be amended to require that Tax Credit project owners certify that their developments are administered in conformity with Title VI of the Civil Rights Act of 1964 and the Fair Housing Act. In addition, state allocating agencies should require owners to develop Affirmative Fair Housing Marketing Plans in accordance with related HUD regulations.

Although not within the scope of the proposals before the Subcommittee, some have suggested additional modifications to the Tax Credit program such as targeting the program to very low income families and extending the low income use restrictions on Tax Credit projects. While we share these concerns that long-term affordable housing for households in greatest need should be a priority, further restrictions on the Tax Credit program without the assurance of the additional subsidies necessary to meet those restrictions would be counterproductive.

The Tax Credit was not designed to provide a deep enough subsidy to serve the lowest income households without additional subsidies. On its own, the Tax Credit is designed to finance projects in which 20 percent of the units serve households at 50 percent of median income or less or projects in which 40 percent of the units serve households at 60 percent of median or less. Nonetheless in 1989, Congress mandated that state Tax Credit allocating agencies "give preference to projects serving the lowest income tenants"

(Section 42(m)(1)(B)(ii)), and through the use of state resources and other federal subsidies, states have gone far beyond the targeting in the law. Virtually every Tax Credit project financed today has 100 percent of its units serving households below 60 percent of median income, and many units are serving families well below that level.

States do their best to meet that mandate within the constraints of the depth of the Tax Credit subsidy. Last year, the Florida State Auditor General conducted a survey of the state's Tax Credit projects. The report shows that the median income of a Tax Credit household in the state of Florida was $9,360, 26 percent of the states' median income. Households with children had an annual median income of $8,363. Overall, 90 percent of the households residing in Tax Credit units had incomes below $17,950, 50 percent of the state's median income.

States like Florida achieve these results because they can combine the Tax Credit with state funds and additional federal subsidies, such as Section 8 rental assistance. Many states cannot provide the same level of assistance. There is no guarantee that Section 8, a direct federal appropriation, will be available for every Tax Credit household who requires it. In fact, the House has passed a budget resolution which will freeze domestic discretionary spending for the next five years, making it even more difficult to provide rental assistance for new households. Until sufficient subsidies are available to augment the Tax Credit program, deeper income targeting will simply cause fewer units to be produced.

We have similar concerns about a proposal to extend the low income use restrictions on Tax Credit projects. Under current law, most projects must remain affordable for 30 years. As with income targeting, Congress has required states to "give preference to projects serving qualified tenants for the longest periods" (Section 42(m)(1)(B)(ii)) and many states have gone beyond what is required by statute. For example, California now requires 55-year low income use on its Tax Credit projects, and for New York projects which combine Tax Credits with the state's "Turnkey" program, a 99-year low income use restriction is required. In order to encourage developers to build projects with such long-term affordability covenants, states must offer incentives beyond the allocation of Tax Credits. Without the assurance of additional subsidies, mandating longer-term affordability is meaningless.

Changes to MRBs and the Tax Credit Are Less Effective if the Programs Are Not Made Permanent

In the end, Mr. Chairman, programmatic changes to these critical housing finance programs will only be effective if Congress accords the MRB and Tax Credit programs the status they have earned as a permanent part of the Tax Code. We look forward to working with the Committee on any changes necessary to make the MRB and Tax Credit programs work as efficiently as possible to provide decent, affordable housing for low income American families who need it.

Thank you for the opportunity to testify today.

Chairman RANGEL. Thank you, Mr. Commissioner.
Mr. Leeper.

STATEMENT OF STEPHEN G. LEEPER, TREASURER, ASSOCIATION OF LOCAL HOUSING FINANCE AGENCIES, AND DIRECTOR OF HOUSING, URBAN REDEVELOPMENT AUTHORITY OF PITTSBURGH, PA.

Mr. LEEPER. Thank you.

The Association of Local Housing Finance Agencies appreciates the opportunity to testify before the subcommittee this afternoon on several revenue proposals pertaining to housing and tax-exempt bonds. I am Stephen Leeper, director of housing for the city of Pittsburgh and I am also the treasurer of ALHFA.

By way of background, ALHFA is a nonprofit national association of professionals in the field of affordable housing finance. Its members are city and county government agencies that finance from a variety of sources, including general Tax Code incentives, homeownership and rental housing opportunities for low- and moderate-income households. Among our members are the housing finance agencies from Chicago, San Francisco, Los Angeles, Pittsburgh, where I am from, and Dade County, Fla.

ALHFA's purpose is to serve its members as an advocate before Congress and the executive branch on affordable housing policy issues, and through educational activities, to enhance the ability of our local housing finance agencies to implement responsible and professionally administered affordable housing programs.

At the outset, Mr. Chairman, I wish to extend ALHFA's appreciation to you and your colleagues for your support of permanent extensions of MRBs, mortgage credit certificates, and the low-income housing tax credits. These programs, which expired on June 30, 1992, are obviously very critical to the creation of decent housing for low- and moderate-income people and essential tools for addressing redevelopment and the elimination of blighted conditions in our urban areas.

We urge you and your House colleagues, who are conferees on H.R. 2264, to ensure that the Conference Committee makes both programs permanent, while also retaining the House-passed provision allowing the use of the 70-percent present-value tax credit with the HOME Investment Partnership funds.

There are a number of miscellaneous housing and tax-exempt bond proposals before the subcommittee about which ALHFA wishes to comment. The written testimony submitted by ALHFA clearly outlines our comments on each of these proposals. However, in the interest of time, I would just like to address three of these proposals.

The first is the proposal to increase the current law limit for MRB-financed home improvement loans. Under current law, Mortgage Revenue Bond proceeds may be used to finance home improvements of up to $15,000. This proposal would increase the ceiling to $25,000. This current ceiling has been in place since the early 1970s and does not reflect the increase in rehabilitation costs, particularly for older homes.

The increase would also make the MRB Home Improvement Loan Program ceiling consistent with the ceiling on the Federal

Housing Administration's Home Improvement Insurance Program, which would be appropriate since both programs are often used together. This proposal is significant to the city of Pittsburgh where over 75 percent of our housing stock is over 50 years old.

The city's redevelopment authority has put a lot of emphasis on its home improvement programs over the last 15 years, during which time we financed over 13,000 loans valued at over $90 million. Due to the $15,000 cap, the redevelopment authority in many instances utilizes its scarce CDBG and HOME funds to offset the difference between the cost of the needed improvements and the maximum loan amount of $15,000.

In addition, many of our elderly homeowners have to forgo improvements because the borrowing limit is in place. Presently, these programs have an average loan amount of $17,000 and serve households with an average income of $17,800. Over 53 percent of our households have incomes below $12,000 a year. This proposed increase in the home improvement loan cap would enable Pittsburgh and other urban areas to redirect precious resources and to expand the residential redevelopment programs.

The second provision I would like to address is allowing the use of the 70-percent present-value, low-income tax credit with tax-exempt bonds. In 1989 Congress amended the Tax Code to permit the full 70-percent present-value credit with Federal CDBG funds. If the House provision which addresses the use of credit and Federal HOME funds prevails in conference on H.R. 2264, the full 70 percent value credit will be permitted.

ALHFA strongly supports and believes that Congress should complete the process by extending the treatment it has provided CDBG funds to HOME funds and tax-exempt bonds. Removing the current penalty which reduces the credit to 30-percent present value when HOME or bond proceeds are used would directly assist local housing finance agencies, particularly those that function in inner-city neighborhoods.

This would not only add to the stock of low-income housing, but it would also create a positive housing environment for low-income households who are its occupants. Present law would ensure that a combination of credit and tax- exempt bonds would not result in oversubsidizing as allocating agencies would be required to provide only the amount necessary to achieve project feasibility. In Pittsburgh, as is the case in most urban areas, the cost associated with substantial renovating or constructing new rental housing is considerable.

Environmental contamination—and we heard the mayor from the city of Chicago talk about industrial sites—in many of our cities at residential sites that have the same contamination resulting from asbestos and lead-based paint, deteriorated public infrastructure, and in some instances, relocation, all add to the cost of rental housing. Local and State governments, in an effort to stimulate investment, provide considerable financial assistance to the developer of rental housing.

The equity provided by the low-income tax credit in and of itself does not provide the necessary financial assistance to make these rental developments feasible. Depending on the number of low-income housing units in a development, the low-income credit pro-

vides between 25 to 45 percent of the total development costs. Many rental developments that serve low-income households with special needs are unable to carry any conventional debt whatsoever. Developments of this nature require State and local governments to provide subsidies totaling nearly 60 percent of the total project costs.

Mr. Chairman, it is imperative that more flexibility be built into the code to enable the State and local governments to structure financing plans that maximize all funding mechanisms available to them. The use of the low-income tax credit with tax-exempt bonds and HOME funds would permit State and local governments to obtain greater benefit from their subsidy dollars.

Finally, there is a proposal permitting tax credits for units occupied by those between 60 percent of the median income up to 110 percent of the median income as long as each such unit is offset by another unit occupied by a household of 40 percent or less of the area median. We believe it adds a level of complexity to the program which we do not believe is appropriate.

As an alternative, ALHFA does support legislation that would further economically integrate our rental developments in urban areas. This could be accomplished by allowing a 30-percent value credit for units that are occupied by households with incomes between 60 and 80 percent of the area median.

This would provide developers with a greater incentive to develop affordable rental housing for low-income renters. In addition, it would further promote the economic integration of our neighborhoods which is essential to the further residential and commercial viability of our inner-city communities.

Thank you for the opportunity to present our views.

Chairman RANGEL. Thank you.

[The prepared statement follows:]

STATEMENT OF STEPHEN G. LEEPER,
DIRECTOR OF HOUSING FOR THE
URBAN REDEVELOPMENT AUTHORITY OF PITTSBURGH

Mr. Chairman and Members of the Subcommittee:

The Association of Local Housing Finance Agencies (ALHFA) appreciates the opportunity to testify before the Subcommittee this morning on several revenue proposals pertaining to housing and tax-exempt bonds. I am Stephen G. Leeper, Director of Housing for the Urban Redevelopment Authority of Pittsburgh and ALHFA Treasurer.

By way of background, ALHFA is a nonprofit national association of professionals in the field of affordable housing finance. Its members are city and county government agencies which finance, from a variety of sources including federal tax code incentives, homeownership and rental housing opportunities for low- and moderate-income households. Among our members are the New York City Housing Development Corporation, the City of Chicago Department of Housing, the City of Los Angeles Department of Housing Preservation and Production, the San Francisco Mayor's Office of Housing, the Dade County, Fla., Housing Finance Authority, my own agency, and many, many more. ALHFA's purpose is to serve its members as an advocate before Congress and the Executive Branch on affordable housing policy issues and, through educational activities, to enhance the ability of local housing finance agencies to implement responsible and professionally administered affordable housing programs.

At the outset, Mr. Chairman, I wish to extend ALHFA's appreciation to you and your colleagues for your support for permanent extensions of the Mortgage Revenue Bond/Mortgage Credit Certificate and Low-Income Housing Tax Credit programs. These programs, which expired last June 30th, are absolutely critical to the creation of decent housing for low- and moderate-income people and are essential tools for addressing the growing problem of blighted conditions and disinvestment in our urban neighborhoods. We urge you and your House colleagues who are conferees on H.R. 2264, the Omnibus Budget Reconciliation bill, to ensure that the Conference Committee makes both programs permanent, while also retaining the House-passed provision allowing use of the 70 percent present-value Tax Credit with HOME Investment Partnership funds.

There are a number of miscellaneous housing and tax-exempt bond proposals before the Subcommittee about which ALHFA wishes to comment:

Tax-Exempt Bond Proposals

- Increasing the Current Law Limit on MRB-Financed Home Improvement Loans - Under current law Mortgage Revenue Bond proceeds may be used to finance home improvements of up to $15,000. This proposal would increase the ceiling to $25,000. The current ceiling has been in place since the early 1970s and does not reflect the increase in rehabilitation costs, particularly for older homes, since then. This increase would also make the MRB home improvement loan program ceiling consistent with the ceiling on the Federal Housing Administration's home improvement insurance program, which would be appropriate since the two programs are often used together. ALHFA strongly supports this increase.

- Allowing MRB Proceeds to be Used for Purchases of New Two-family Houses in Certain Distressed Areas - Under current law MRBs may be used to finance new single family homes, but not two-family homes. They may also be used to acquire existing property of up to four units. H.R. 1913, introduced by Rep. Serrano, would permit MRB financing of newly constructed two-family homes in targeted areas or in any economic development or enterprise zone under federal or state law. ALHFA supports this proposal, but believes that it should be expanded to as many as four units, the same as for existing housing. In New York City, for example, the costs of land and construction make two-to-four family housing more economically feasible than single-family homes. By expanding homeownership opportunities this change would also free up rental housing for other low- and moderate- income households in need of such housing.

We see no difference between allowing MRBs for existing two to four family homes and not permitting them for new two to four family homes, particularly since their permitted use for new two to four family housing would create jobs.

While this proposal is not the subject of today's hearing because it was included in H.R. 11, last year's urban aid tax bill, we want to reiterate ALHFA's strong support for a proposal which clarifies that shared appreciation/subsidy lien second mortgage programs used in tandem with MRBs do not constitute an ownership interest on the part of the issuer, are excluded from the acquisition cost limits of the program, and have no effect on the "effective rate of interest" on first mortgage loans financed from an MRB issue. This is a technical change intended to clarify a grey area of the law in order to ensure that second mortgage programs can be used with MRBs. We urge the Subcommittee to again approve this proposal.

- Increasing the Bank Deductibility Limit from $10 Million to $20 Million - This proposal was one of those formulated by the Anthony Commission on Public Finance. It would broaden the market for tax-exempt bonds, including housing bonds, and lower the borrowing costs of state and local governments, while providing additional capital for community reinvestment. ALHFA supports this proposal.

Low-Income Housing Tax Credit Proposals

- Deep Rent Skewing - This proposal would allow multifamily housing projects developed with Low-Income Housing Tax Credits allocated before 1989 to use the same rent skewing between market rate rents and rents on the set-aside units that is permitted for projects to which credits were allocated after 1989, i.e., a 2 to 1 rather than a 3 to 1 ratio. ALHFA supports this change, which is included in the Senate-passed version of H.R. 2264, as a matter of equity. Two types of projects would be affected by it: those that elected rent skewing under the three-times rule but which are now having financial difficulty because of a declining real estate market, and those that did not elect rent skewing because they could not then meet the three-times rule but which could do so now.

- Carryforward - This proposal would treat credits carried forward from previous years as used before current-year credits. ALHFA supports this proposal which basically is "last in, first out." The carryforward provision under current law requires that the current year allocation of credits be used before carryforward credits may be used. Thus, if a housing credit agency is unable to allocate all of its credit authority in a given year it will not be able to allocate its carryforward authority and it will lose it to the national pool. Since the carryforward provision is intended to protect credit agencies from losing credit authority in instances in which they are unable to fully allocate, they should not be penalized as they are under current law.

- Allowing Use of the 70 Percent Present Value Credit with Tax-Exempt Bonds - In 1989 Congress amended the Tax Code to permit the full 70 percent present value credit with federal Community Development Block Grant funds (91 percent in high cost areas). If the House provision dealing with the credit and federal HOME funds prevails in Conference on H.R. 2264, the full 70 percent present value credit will be permitted with these funds. ALHFA strongly believes that Congress should complete the process by extending the treatment it has provided to CDBG funds to HOME funds and to tax-exempt bonds. Removing the current law penalty which reduces the credit to 30 percent present value when HOME or bond proceeds are used would directly assist local housing finance agencies, particularly those which function in innercity neighborhoods, to stimulate the production of a significant amount of new, mixed-income housing. This would not only add to the stock of low-income housing, but it would also create a positive housing environment for the low-income households who are its occupants. Present law would ensure that a combination of the credit and tax-exempt bonds would not result in over-subsidizing a project, as allocating agencies would be required to provide only the amount necessary to achieve project feasibility.

- Permitting Tax Credits for Units Occupied by Those Between 60 Percent of the Median Income Up to 110 Percent of Median Income as Long As Each Such Unit is Offset By Another Unit Occupied By a Household at 40 percent of Median or Less - ALHFA strongly supports efforts to promote mixed income housing. However, this proposal adds a level of complexity to the program which we do not believe is appropriate. ALHFA supports the targeting requirements of current law. We also would support additional credits, perhaps at 30-percent present value, for units occupied by households between 60 and 80 percent of area median income. However, to require a corresponding number of units at 40 percent of median income or below would jeopardize the financial feasibility of the project and preclude economic integration of residential housing projects in innercity neighborhoods.

- Providing Treasury with Authority to Waive Penalties For De Minimis Errors in the Application of Occupancy Requirements - ALHFA supports this useful modification to current law in instances where there are inadvertent errors which can be corrected rather than triggering a recapture of credits. It is included in the Senate-passed version of H.R. 2264.

- Providing Treasury with Authority to Waive the Annual Requirement for Tenant Income Recertification for Buildings Entirely Occupied by Low-Income Tenants - ALHFA supports this useful modification of current law as it will reduce the administrative burden of project owners and credit allocation agencies who monitor recertification compliance. It is included in the Senate-passed version of H.R. 2264.

In addition to the changes to the tax credit program which are before the Committee we would also like to add ALHFA's voice of support to several technical changes included in the Senate-passed version of H.R. 2264 and urge the House Conferees to include them in the Conference version of that legislation:

- requiring the housing credit agency to consider the reasonableness of the development and operational costs of a project as an additional factor in making its determination of the amount of credit to allocate to a project. We would caution, however, that a reasonableness test must take into account the higher cost of constructing housing in "high cost" areas;

- allowing units occupied by full-time students to qualify for the tax credit if the full-time students are a single parent and his or her minor children and none of the tenants is a dependent of a third party. The amendment would also codify the present-law exception regarding married students filing joint returns (which continues to apply to all buildings placed in service since original enactment of the credit in 1986);

- allowing an irrevocable election by the owner of a low-income building placed in service before 1990 to use either apartment size or family size in determining maximum allowable rent. The election would be available only to taxpayers who enter into a compliance monitoring agreement with a housing credit agency. Further, the election would apply only with respect to tenants first occupying any unit in the building after the date of the election and must be made within 180 days after the date of enactment;

- prohibiting the denial of admission to a low-income tax credit project because the prospective tenant holds a Section 8 certificate or voucher; no owner could terminate tenancy or refuse to renew a lease except for serious or repeated violations of the lease terms or for other good cause; would apply fair housing laws to tax-credit supported housing;

Thank you for the opportunity to present ALHFA's views.

Chairman RANGEL. Mr. Peace.

STATEMENT OF ROGER GLUNT, PRESIDENT, NATIONAL ASSOCIATION OF HOME BUILDERS, AS PRESENTED BY J. LEON PEACE, JR., TAX COUNSEL

Mr. PEACE. Thank you, Mr. Chairman, members of the subcommittee. My name is J. Leon Peace, Jr. I am tax counsel for the National Association of Home Builders. I apologize that Mr. Glunt is unavailable to testify here today, but he has been called away to another appointment.

On behalf of the National Association of Home Builders and its 160,000 members, Mr. Chairman, I congratulate you for calling this hearing and appreciate the opportunity to appear here today. My comments will address several of the proposals pertaining to the low-income housing tax credit and the rehabilitation tax credit, as well as the Mortgage Revenue Bond Program.

At the outset, Mr. Chairman, I would like to point out that the National Association of Home Builders supports the House, as opposed to the Senate, version of the budget reconciliation bill in part because of its provision for the permanent extension of both the low-income housing tax credit and the Mortgage Revenue Bond Program. It has long been our policy that these programs are equally important to meeting the need for affordable housing.

More efficient use of tax credits for low-income housing and rehabilitation, as well as the MRB programs, will help meet the growing need for affordable housing. In this regard, we are concerned with the correction of a flaw in the current language with respect to the so-called "stacking rule" of the low-income tax credit.

The stacking rules create an unmanageable problem in that a State that fails to use all its current year authority by year end will lose any prior year authority to the national pool, in effect, giving that State only 1 year of tax credit authority where Congress clearly intended to give 2.

In 1992, this problem caused a premature shift of tax credit authority for over 5,000 low-income housing units from States to other States and deprived nearly 7,000 low-income families of needed affordable rental housing. This year, 37 States stand to lose tax credit authority for about 28,000 units to the national pool. Another 8,500 low-income families in eight States stand to lose needed affordable rental housing entirely. NAHB supports the proposal to stack credit authority carried forward from the previous year before the current year's per capita credit authority.

Due to the credit crunch, permanent debt financing for all forms of multifamily housing production, including debt for tax credit projects, has been in very short supply.

Conventional lenders are often most reluctant to lend to multifamily projects that involve tax credits because these projects typically involve complex, multiparty financing arrangements. By allowing for the full 9 percent tax credit to be made available to projects financed with tax-exempt bonds and other below-market Federal loans, Congress would enable housing finance agencies and other lenders to get back into the business of providing permanent financing for tax credit projects.

While there may be some concern that such a change would result in too rich a subsidy, we would argue to the contrary. The State credit agencies are already charged with the responsibility of allocating the credit in amounts limited to those which make the project feasible. This would merely provide them with one more tool to use in developing sound projects. NAHB urges that these provisions be enacted this year to prevent the further loss of much needed affordable rental units.

The MRB program has been one of the most effective programs in addressing the affordable homeownership problem for first-time buyers. However, the current $15,000 limit on the size of qualified home improvement loans limits the ability of moderate-income taxpayers, to whom the program is targeted, to capitalize on the equity in their homes. NAHB supports the proposal to increase the maximize size of qualified home improvement loans under the MRB program from $15,000 to $25,000.

Another substantive point that must be addressed is the recapture provision enacted in 1990. The provision not only discourages participation in the program, it is so onerous as to defeat the purpose of the program. Without the use of the accumulated equity, many homeowners cannot continue on the ladder of homeownership. Moreover, the impact of carrying such homes and inventory can be devastating to the builder and causes administrative difficulties for State housing agencies.

Finally, we would like to thank Representative Barbara Kennelly for introducing H.R. 1406. We commend her for her unwavering support for affordable housing and for eliminating tax impediments to its creation.

NAHB believes that the amount of rehabilitation credit that individual investors can utilize under the "passive loss" rules should be increased. We understand that there is a possibility that absent such change there will not be sufficient investor equity to fund all projects which will be produced under the program. Although we would prefer to see a complete repeal of the $25,000 loss limitation with respect to the low-income housing tax credit and the rehabilitation tax credit, we urge the passage of 1406 as a step in the right direction. NAHB urges the passage of these proposals as soon as possible.

Mr. Chairman, that concludes my remarks. I would be delighted to answer any questions you have on my statement.

Chairman RANGEL. Thank you, Mr. Peace.

[The prepared statement follows:]

STATEMENT OF THE NATIONAL ASSOCIATION OF HOMEBUILDERS

before the

SUBCOMMITTEE ON SELECT REVENUE MEASURES

of the

HOUSE COMMITTEE ON WAYS AND MEANS

July 13, 1993

Mr. Chairman, members of the Subcommittee:

My name is Roger Glunt. I am a home builder from Turtle Creek, Pennsylvania and am President of the National Association of Home Builders. On behalf of the National Association of Home Builders (NAHB) and its 160,000 members, I congratulate you for holding this hearing and appreciate the opportunity to appear here today. My testimony will address several of the miscellaneous revenue proposals before you during this series of hearings which directly impact housing production. Specifically, I will address the proposals with respect to the modification of the Low-income Housing Tax Credit (LIHTC), Rehabilitation Tax Credit, and Mortgage Revenue Bond (MRBs) programs, Contributions-in-Aid-of-Construction (CIAC), and Export of Unprocessed Timber.

In the past few years, while the country experienced a recession, the housing industry suffered through a de facto depression. The destabilization of real estate and a "credit crunch" transformed the housing segment from a source of economic growth to a source of economic stagnation.

The housing industry has traditionally led the U.S. economy out of recessions. It has done so seven times since World War II. Last year, however, while single family home building experienced some improvements, the housing recovery was modest by historical standards, and the lack of vigor in the housing recovery was a factor in the very limited recovery in the overall economy. Housing continues to lag behind past recoveries and real estate values continue to suffer. We believe that federal tax policy must contain initiatives that will remedy the weakness in the housing industry. In any event, federal tax policy should not exacerbate the weakened condition of the industry. We further believe there will be no sustained economic recovery without a recovery in the housing industry.

Multifamily Rental Demand

Demand Growth

The multifamily housing picture is less than encouraging.

Each year through the 1990s, an additional 350,000 multifamily units will be needed to accommodate an increased number of households and to replace existing units removed from the housing stock. Approximately 300,000 multifamily units will probably be needed in buildings with 5 or more units with the balance in 2 to 4 unit buildings. Most of the growth in the demand for multifamily rentals will be among moderate-, low and very-low income households.

The demand for additional multifamily rental housing is the sum[1] of the projected growth in multifamily renter households, the projected demand for units to replace the number that are lost on net from the available stock, and changes in the number of vacant units needed to accommodate household growth.

Meeting the Demand

The Joint Center for Housing Studies of Harvard University study of the State of the Nation's Housing in 1991 concluded that "today's level of multifamily starts is well below that required to accommodate even modest projected increases in renter households--let alone allow for replacement of units demolished or otherwise removed from the inventory." Demand for multifamily housing is about 350,000 units per year and the level of multifamily starts in 1991 is only half that number[2].

Although there is currently an excess supply of vacant units in certain regions, net additions to the rental stock from changes in the existing stock and new construction will almost certainly not be sufficient to meet the future demand for multifamily housing unless steps are taken soon to encourage new construction. An undersupply of multifamily rentals will cause rental markets to tighten, rents to rise, and housing cost burdens on the poor to increase. A lack of affordable rental housing could lower the rate of household formations. Some who might otherwise form renter households may be forced to double up with other families, remain in their parents' homes, and, in the worst case, end up homeless.

Since the Tax Reform Act of 1986, multifamily production has plummeted and except for units built under the LIHTC, what little production that has been taking place has been targeted towards middle- and upper-income renters. In 1985, 56 percent of all multifamily completions rented for less than $450, but by 1989 only 19 percent were so rented. This has contributed to an annual average net loss of 324,000 multifamily rentals with rents under $450 between 1985 and 1989[3]. The loss of these units has meant greater hardships for low-income renters and has reduced the flow of existing moderate-income units into the low-income stock.

Virtually all of the limited volume of multifamily rental construction since 1986 that has been intended for low and moderate income families has been supported by the low income tax credit program -- the only remaining tax incentive for production of affordable rental housing.

Single-Family And Homeownership Statistics

In the single-family area, homeownership rates among young families have fallen. The decline in homeownership began in 1980 and continued through 1989 before reversing itself slightly in 1990. The 1990 homeownership rate of 64.1 percent remains well below the 65.6 percent of 1980. The most dramatic drop in the homeownership rate during that period has been among young families who typically are first-time buyers.

The Harvard Joint Center for Housing Studies 1992 report, "State of the Nation's Housing," found that high costs continue to limit access to homeownership for many potential first-time buyers. Only those age 65 and over have shown any increase in homeownership rates since 1980. Much of that shift is attributable to changes in the distribution of income. The share of income flowing to young families has fallen despite the greater number of young families with two earners in the labor force.

The demand for single-family homes should be strong during the 1990s. Single-family starts should not be affected by the expected slowdown in household growth relative to past decades because changes in the age structure of the population will favor higher rates of homeownership, and greater demand for single-family homes.

Multi-Family Statistics

Our analysis indicates the LIHTC supports the construction or rehabilitation of about 130,000 low income rental units each year including 60,000 to 70,000 new units. The LIHTC is responsible for more than one-third of all 1992 multifamily starts, nearly half of all rental multifamily starts, and virtually all the new rental units available to households with incomes under $15,000[4].

Assuming the permanent extension of the LIHTC, tax credit assisted units will probably account for about eighteen percent of all multifamily completions and one quarter of multifamily **rental** completions over the remainder of the decade. More importantly, tax credit assisted units would account for as much as 93 percent of all low-income multifamily rentals completed in the 1990s. Under the current program, the credit obtains 70% usage. It is axiomatic that, to obtain the maximum amount of usage per dollar, the program must be made easier to use.

Low-Income Housing Tax Credit--State Credit Authority Limitation: Stacking Rule

The Code provides for the use of the total amount of annual credit authority for a state (state housing credit ceiling). This ceiling is equal to the population component (typically $1.25 per capita) plus unused authority from the previous year, plus credit authority from the national pool. States are allowed two years to allocate their per capita authority. The national pool consists of authority that sates did not use in the allocated time frame. The pool is distributed to states based on population. To be eligible for national pool authority, states must have used all of their authority for the prior year. In practice, therefore, the annual authority for a state is the population component plus either the unused authority from the previous year or the national pool authority.

Under the order of use, or "stacking rules", the population component must be used first before previous year authority or national pool authority. At the end of the year, the unused population component may be carried over to the next year for use in the state; the unused previous year authority for a state , if any, goes to the national pool for use in other states; and the unused national pool authority is returned to Treasury.

The stacking rules create an unmanageable problem in that a state that fails to use all of its current year authority by year end will lose any unused previous year authority to the national pool, in effect giving that state only one year of tax credit authority where Congress clearly intended to give two.

In 1992, the stacking rule problem caused the premature shift of tax credit authority for over 5,000 low income housing units from some states to others and deprived nearly 7,000 low income families of needed affordable rental housing. The need for remedy of this problem is immediate. Thirty-seven states stand to lose tax credit authority for about 28,000 units to the national pool in 1993. Another 8,500 low income families in eight states stand to lose needed affordable rental housing.

The legislative history with respect to the carryover rule clearly indicates that it was Congressional intent to allow states a two year period within which to use tax credit authority. NAHB urges the implementation of this proposal as soon as possible to prevent the loss of sorely needed affordable housing.

Low-Income Housing Tax Credit--Projects Financed by Tax-Exempt Bonds

Like all multifamily projects, tax credit assisted projects depend on the availability of debt financing. Due to the credit crunch, permanent debt financing for all forms of multifamily housing production, including that for tax credit projects, has been in very short supply. Conventional lenders are often most reluctant to lend to multifamily projects that involve tax credits because these projects typically involve complex multi-party financing arrangements. Congress is in a unique position to help solve this problem. By allowing for the full nine percent tax credit to be made available to projects financed with tax-exempt bonds and other below market federal loans, Congress would enable housing finance agencies and other lenders to get back into the business of providing permanent financing for tax credit projects.

While there may be some concern that such a change would result in too rich a subsidy, we would argue to the contrary. The state credit agencies are already charged with the responsibility of allocating the credit in amounts limited to those which make the project feasible. This would merely provide them with one more tool to use in developing sound projects. Moreover, the cost of such a change would be minimal. Both the LIHTC program and the tax-exempt bond program are already accounted for, hence, their combined use would have little, if any, revenue impact.

NAHB urges the implementation of this proposal.

Treatment of Rehabilitation Tax Credit Under the Passive Loss Rules (H.R. 1406)

We would like to thank Rep. Barbara Kennelly (D-CT) for introducing H.R. 1406, which bill would repeal the adjusted gross income phaseout for rehabilitation credits under the passive loss rules and would increase the $25,000 deduction equivalent amount to $65,000. We commend Rep. Kennelly for her unwavering support for affordable housing and eliminating tax impediments to its creation.

NAHB believes that the amount of rehabilitation credit (and LIHTC) individual investors can utilize under the passive loss rules should be increased. We understand that there is a possibility that, absent such change, there will not be sufficient investor equity to fund all the projects which will be produced under the program. Although NAHB would prefer to see a complete repeal of the $25,000 loss limitation with respect to the low income housing tax credit and the rehabilitation tax credit, we urge the passage of H.R. 1406 as a step in the right direction.

Mortgage Revenue Bonds

The MRB program has been one of the most effective programs in addressing the affordable homeownership problem. More importantly, the MRB program addresses the problem at minimal expense. The current $15,000 limit on the size of the qualified home improvement loans limits the ability of moderate income taxpayers, to whom the program is targeted, to capitalize on the equity in their homes.

Another substantive point that must be addressed is the recapture provision enacted in 1990. The provision not only discourages participation in the program but is so onerous as to defeat the purpose of the program. By way of example, one builder has informed us that he has been unable to sell much needed affordable homes, which he built in reliance on the prospective purchasers being able to utilize MRBs, because of buyer fear of the recapture provisions. Without the use of their accumulated equity, many homeowners cannot continue on the ladder of homeownership. Moreover, the impact of carrying such homes in inventory can be devastating to the builder and causes administrative difficulties for the state housing agencies.

NAHB urges you to increase the maximum size of qualified home improvement loan under the MRB program. We also encourage your re-examination of the recapture provision.

Treatment of Contributions in Aid of Construction (CIAC)

CIACs are payments that a utility requires from a new customer to compensate the utility for the cost of equipment that the utility must buy to serve that customer. The changes to CIAC made by the Tax Reform Act of 1986 worsened the affordable housing problem. Prior to the 1986 Act, the Internal Revenue Code Section 118(a) excluded from gross income any contribution to the capital of a corporation. In order to be treated as a contribution to capital, an amount paid to a corporation had to be motivated either by donative intent, or a belief that the contributor would somehow be advantaged by the enlargement of the capital of the corporation.

Specifically, Code Sec. 118(b) provided that a corporate regulated public utility that provides electric energy, gas, water, or sewage disposal services could treat contributions received in aid of construction as nontaxable contributions to capital.

Several requirements had to be met in order for a payment to a utility to be treated as a CIAC under Code Sec. 118 (b): First, the money or other property transferred to the utility had to be an contribution in aid of construction; Second, any money received had to be spent for the intended purpose of the contribution within a specified period of time; Third, the CIAC could not be included in the utilities rate base or rates allowable with respect to a CIAC. Finally, property purchased with such a contribution had no depreciable tax basis and was not eligible for the investment tax credit.

Over the years, a substantial body of case law developed legal and financial theories for the non-taxation of CIAC. Specifically, in Liberty Light and Power Company, 4 B.T.A. 155 (1926); acq. VI-1 C.B. 4 (1927), it was determined that contributions of utility lines future users were a contribution of capital and not prepayments for services. This rule controlled until the 1970's when the Supreme Court ruled, in U.S. v. Chicago, Burlington & Quincy Railroad Co., 412 U.S. 401 (1973), that the value of the property received was income if it could be traced to the provision of specific quantifiable services.

Initial Congressional response to the erosion of the capital contribution concept was displayed in both the Tax Reform Act of 1976 and the Revenue Act of 1978, wherein specific language provided that CIAC made to water and sewage companies (1976 Act), as well as gas and electric utilities (1978 Act) were non-taxable.

The 1986 Act repealed Section 118(b) to require corporate regulated public utilities to report as an item of gross income cash or the value of any property received to provide services to the person transferring the cash or property. Congress believed that such contributions represented prepayments for services. As a result, CIAC received after 1986 are taxable to the utilities in the year of receipt. Utilities have increased, or "grossed up" the amount of the CIAC they require to compensate for the tax. The term "grossed up" refers to the series of mathematical calculations required to determine the amount of money needed to offset the tax liability. The "gross up" represents the taxes paid on the contribution plus the tax on the tax, adding up to 70 percent to the builder/developers' cost.

Most public utilities prohibit the inclusion of the cost of the added liability in the rate base. If this were allowed, the cost would be spread to all consumers. The utilities simply consider the increased tax liability as an increase in the cost of adding new customers. As a result, most utilities charge the builder/developers, who are frequently the customers in these cases, a fee for transferring capital CIAC that is equivalent to the tax. Builders must pass these costs on to the buyer. As a result, the price of housing has risen as much as $1,000 - $2,000 per unit, thereby making housing unaffordable for many Americans. Worse, the cost to the buyer is generally greater than the tax because the builder must borrow these funds during the development stages but does not recoup them until sale. Accordingly, home costs are increased by a multiple of the "gross up" to compensate for time and risk to the lender.

The CIAC tax has had an uneven national impact, depending upon whether the particular area is served by a regulated public utility or tax-exempt municipal or county utility, or the method of determining the "gross up". The methods differ between states, types of utilities and individual corporations. However there are two basic categories: the full gross up and net present value gross up.

Full Gross Up

The full gross up has the most devastating impact on builders. It involves collecting the full amount of the federal and local taxes on the CIAC, plus the full amount of taxes due on the tax payment. The formula used is ((Tax Rate / 1-Tax Rate)) x CIAC. With a 34% federal tax rate and a 6.5% state/local tax rate this would result in a gross up to cover the tax on CIAC of 62%. Under the full gross up method the contributor is not given credit for the depreciation benefits that the utility will be able to take in future years.

Net Present Value Gross Up

The net present value gross up is based on the idea that the additional charge imposed on the builders should reflect the future depreciation. This method puts the utility at some risk because changes in tax rates can cause lower (or higher) than expected depreciation benefits over the tax life of the contribution. In the event of loss, it may be absorbed by shareholders or be passed on to the ratepayer, depending on state public utility commission regulations.

Present value of future depreciation depends on which discount rate is to be used. Suggestions include government bond rates, the utilities rate of return from their last filing plus a risk premium. By way of example, assuming a 20 year taxable life for a CIAC, a 34% federal tax rate, and a 6.5% state/local tax as used above, the net present value method results in a gross up of roughly 23%, based on a discount rate of 17%. A higher rate of return would result in a larger gross up collected, and vice versa.

Each Congressional session since the imposition of the tax on CIACs, legislation has been introduced which would have repealed the CIAC tax. In this regard, we would like thank Rep. Bob Matsui (D-CA) for his tireless efforts in sponsoring legislation which would restore Internal Revenue Code section 118(b) exempting CIAC from gross income. This session, Rep. Matsui has introduced H.R. 846.

According to Joint Tax Committee estimates, repeal of the tax will cost $108 million over a five year period. To offset this cost, H.R. 846 provides for the extension of the depreciable life of water utility property from 20 to 25 years under the straight-line depreciation method, generating revenue of $140 million over the same period.

While NAHB would prefer to see the tax on CIAC completely repealed, this proposed change will help to bring down home prices, and make housing more affordable throughout the country.

Log Exports

In 1992, timber growers exported more than 3 billion board feet of raw logs, more than half of which went to Japan. From October 1992 through March 1993, lumber prices more than doubled, adding as much as $5,000 to the cost of a new home, thereby severely impacting housing affordability in this country.

At a time when Northwest mills are closing due to a lack of timber to process, and a severe dropoff in timber supply is having a dramatic effect on the price of lumber, it is not in our nation's best interest to maintain a tax subsidy for log exporters. We would like to express our appreciation to Rep. Peter DeFazio (D-OR) for introduction of his bill, H.R. 1997 to eliminate the tax incentives for raw log exporters and Rep. Mike Kopetski (D-OR) for his support of eliminating such tax incentives. We would hope the Members could work together to get a bill to address this important issue this year.

The President's plan announced on July 1, provides for eliminating tax incentives for raw log exporters and provides for increased domestic processing. Moreover, the Senate version of the Budget reconciliation bill eliminating such tax advantages lends further support to our position that this issue should be given prime consideration during this legislative session. The changes proposed in H.R. 1997 will promote employment in the lumber industry, help to bring down lumber prices, and thereby make housing more affordable throughout the country.

CONCLUSION:

The National Association of Home Builders urges the passage of these proposals as soon as possible. This concludes my remarks. I would be glad to answer any questions you have about my statement.

END NOTES

1. Total housing production in the 1990s will average 1.5 million housing units. The source of demand will be comprised of 1.16 million additional households per year, .13 million more unit to maintain vacancies, and .21 million replacement units for removals.

2. *The Future of Home Building - 1992 to 1994 and Beyond,* National Association of Home Builders, 1992, p. 9.

3. *The Future of Home Building - 1992 to 1994 and Beyond,* National Association of Home Builders, 1992, p. 184.

4. Approximately 65,000 LIHTC units were started in 1992, compared to 170,000 units in buildings with 2 or more units of which 129,000 were offered for rent. Incomes below $15,000 are capable of paying $375 per month in gross rent (including utilities) which is below the return necessary for an average market rate unit.

Chairman RANGEL. Ms. Borton.

STATEMENT OF PAMELA K. BORTON, CHAIRPERSON AND PAST PRESIDENT, COUNCIL FOR RURAL HOUSING AND DEVELOPMENT, AND PRESIDENT, SOUTHWIND MANAGEMENT COMPANY, CLEARWATER, FLA.

Ms. BORTON. Thank you, Mr. Chairman, members of the subcommittee. I want to thank you for the opportunity to testify at this hearing.

As you indicated, my name is Pam Borton and I am currently Chair and past president of the Council for Rural Housing and Development. I am also president of Southwind Management Services which is a property management firm based in Clearwater, Fla. The firm specializes in the management of low-income housing programs, most notably those properties that are financed through the Farmers Home Administration 515 Rural Rental Housing Program.

As a matter of background, the Council for Rural Housing and Development is made up of over 350 developers, financiers, and managers of projects under the Farmers Home Administration's 515 program. Our membership also includes 22 State-affiliated member associations. It is on behalf of the Council for Rural Housing Development that I speak today.

Mr. Chairman, although I do understand that the purpose of today's hearing is to address certain specific housing issues as they relate to the low-income housing tax credit, I think that we would be remiss if we did not thank you personally for your outstanding leadership in preserving and improving the tax credit.

I have had the pleasure of speaking before you in the past and have listened to your affirmation of how much the credit has done to housing in your district. You have toured some of your communities, and they really have been an asset. We want to encourage you to go ahead and make this tax credit permanent, which, of course, is currently in both budget reconciliation bills.

But as important as the extension of the tax credit is, there are some other issues that relate to the tax credit that I would like to take a moment to address today. And I would like to follow those comments by some other issues that are not currently on the agenda of the tax credit issues before the committee but that we believe are equally important and should find some dialog somewhere down the road.

In 1990, Congress passed legislation to make full-time students eligible for occupancy in a tax credit unit when they are the head of the household and receive Aid to Families with Dependent Children, or AFDC. It seems contrary to this committee's agenda, as well as that of the current administration, to make the collection of welfare benefits a condition of housing.

I know as a practitioner of property management, it is very difficult for me to explain to a rejected low-income applicant who is a full-time student and is independent and out on his own, that he is not eligible, and yet I am permitted to accept the low-income, single-parent AFDC recipient.

You know, the whole purpose, I believe, of low-income housing is to encourage upward economic mobility. By making welfare payments a condition of housing for some, while others are out there

trying to make it on their own and are being rejected for that affordable housing, is just a terrible inequity.

We would encourage that the conference committee on the budget reconciliation bill also be urged to look at the full-time student issue for some redress because of the inequities that are created.

One of the other issues was already, I think, admirably addressed today by Congressman Schumer, which is the relief on taxation on reserves. I would encourage there be thought given, however, not to limit this just to co-ops, but extend it to all low-income housing.

We have heard from Mayor Daley om abandoned industrial sites. We are going to experience that with housing as well if we continue to penalize good stewardship, which is the creation of those reserves, through the current taxation laws that apply to the reserves.

We are encouraging a change in that part of the tax law, except for when the reserves, of course, are actually used, and then we understand that the interest earned on the reserves should be treated as taxable income.

There has also been comment today about the preservation of the historic properties by converting them into low-income housing tax credit properties. We would urge that there be consideration given to lifting the $200,000 to $250,000 phaseout for the investors that are permitted to invest in the historic rehab.

We believe that this is extremely important, otherwise you are sending a signal that the historic rehab properties don't deserve the same or equal credit as other tax credit properties. This actually may discourage the preservation of some of the historic rehab because the developer knows he is not going to get investors, who are going to want to buy into the deal, simply because of the limitations on the income cap.

On community service facilities, which is one of the other issues before the committee, we believe that the proposal to include ineligible basis, the cost associated with community service facilities, as contained in Senate bill 487, introduced by Senators Mitchell and Danforth, would be useful as an addition to Section 42. However, we seriously question one aspect of that legislation, which would restrict this provision only to qualified census tracts. We don't understand that provision.

We believe that if it is important enough to consider the cost basis of community facilities for tax-credit properties' viability, we should look at all tax credit properties, not just those in census tract areas.

Some of the other issues which we support are the proposal to permit Treasury waivers. As a property manager, I would really encourage consideration of this.

It is very easy for inadvertent and the small arithmetic errors to occur. They can be corrected down the road.

We would like the Treasury Department to be permitted to waive penalties for these type of de minimis errors. We think that they should be given that discretion as it is extremely important to the actual practice of the tax credit program.

With respect to waiver of annual recertifications on 100-percent low-income buildings that are assisted only by the tax credits, we

don't believe there is any reason to recertify those incomes since there is actually no penalty upon either the developer, the owner, or the tenant, and it would eliminate a lot of paperwork burden and unnecessary and costly procedures.

One of the most important issues that we are facing as an organization particularly deals with Farmers Home 515 and the discrepancy that we currently have between the basic rents that we are required to charge by the lending agency and the maximum tax credit rents that are allowable. We would like, and have spoken before this committee in the past on that particular issue, that there be some attention to redress there.

What occurs is, in essence, if 30 percent of a tenant's adjusted monthly income translates into $275, and the Farmers Home basic rent is $250, for tax credit projects that were allocated credits in 1987, 1988 and 1989, the owners or developers of those properties are actually faced with buying down that $25 difference since the Federal agency that has financed them does require that we remit the entire dollar amount. So we would encourage consideration of changing that.

Chairman RANGEL. Ms. Borton, we have run out of time here.

Ms. BORTON. I do want to thank you for giving us an opportunity to present these issues before the committee today.

Thank you.

[The prepared statement follows:]

STATEMENT OF PAMELA K. BORTON
COUNCIL FOR RURAL HOUSING AND DEVELOPMENT

Mr. Chairman and Members of the Subcommittee, thank you for this opportunity to testify at this hearing. My name is Pamela K. Borton and I appear today on behalf of the Council for Rural Housing and Development of which I am Chairperson and Past President. I am also President of Southwind Management Company, a real estate property management firm specializing in the management of low-income rental properties and particularly, those assisted under the Farmers Home Administration Section 515 rural rental housing program.

As a matter of background, the Council is an organization of over 350 developers, financiers and managers of properties under the Farmers Home Section 515 program. Our membership also includes 22 affiliated-member state associations.

Mr. Chairman, although I understand this hearing concerns certain specific housing issues, most of which relate to the Low-Income Housing Tax Credit, we would be remiss if we did not thank you for your years of outstanding leadership in preserving and improving the Tax Credit. We know you will be doing all you can to assure that the Tax Credit is made permanent in conjunction with the upcoming Conference Committee deliberations. As you know, both the House and Senate provided for permanent extensions in their Budget Reconciliation bills. While the issues being discussed today are significant, they all pale in importance to a permanent extension of the Tax Credit.

I would like now to proceed to a discussion of several of the issues before the Subcommittee.

ELIGIBILITY OF SINGLE PARENTS WHO ARE FULL-TIME STUDENTS FOR THE LIHC

In 1990, Congress passed legislation to make full time students eligible for occupancy in a Tax Credit unit when they are the head of the household and receive Aid to Families with Dependent Children (AFDC). This was a very important program change as it enabled many previously ineligible households to become eligible for Tax Credit housing. Unfortunately, there are still families being turned away from housing because they do not collect AFDC and therefore do not fall into this narrow window of eligibility. We believe low income tenants should be encouraged to attend school and so long as they are single and not the dependent of a third party and fall into the eligible income definition, they should not be denied residency. We note that the Senate Budget Reconciliation bill contains this provision and we urge its adoption by the Conference Committee.

RELIEF ON TAXATION OF RESERVES

The proposal to provide relief to co-ops from tax on interest on reasonable reserves and from other income sources should be expanded to provide relief from all required reserves maintained by all owners (not just co-ops), particularly where the reserve amounts revert to the agency requiring the reserves upon termination of the agency's assistance or mortgage. Moreover, reserves in such cases cannot be utilized without the agency's consent. Thus, under present law, reserves and interest thereon which are eventually paid over to the agency and which are tightly controlled by agency requirements are nonetheless taxable income to the owner. Except when the reserves are actually used by an owner, the reserves and interest earned on reserves held by all owners should not be treated as taxable income.

REMOVAL OF THE $200,000 INCOME LIMIT FOR HISTORIC REHABILITATION TAX CREDITS USED IN CONJUNCTION WITH THE LIHC

Those wishing to preserve historic properties by converting them into low-income housing Tax Credit properties are discouraged from doing so by an anomaly in the existing law. In 1989, the Congress repealed a provision that had prohibited investors with incomes of over $200,000-$250,000 from utilizing some or all of the low-income credit. However, it left in place a similar provision with respect to the historic rehabilitation credit. Most publicly offered partnerships which invest in low-income credit properties have a number of investors whose incomes are more than $200,000 and who are thus unable to utilize historic credits. The result is that these investment partnerships are not particularly interested in historic credit/low-income housing credit projects. Those developing such projects, knowing that many of their potential investors will be uninterested in historic credits, have no incentive to attempt to preserve these properties' historic features by utilizing the historic credit. There is no reason to maintain this distinction between credits; at a minimum, the $200,000-$250,000 income phase-out rule should be repealed for properties which are eligible for and receive both the historic and low-income credits.

COMMUNITY SERVICE FACILITIES

We believe that the proposal to include in eligible basis the costs associated with community service facilities, as contained in S.487, introduced by Senators Mitchell and Danforth, would be a useful addition to Section 42. However, we seriously question one aspect of that legislation, which would restrict this provision only to qualified census tracts. If the Congress determines that allowing the basis associated with community service facilities (such as day care centers) to be included in eligible basis, there is no rationale for only permitting this treatment in qualified census tracts. Such facilities may be just as important and useful to the overall success of a property in areas outside of qualified census tracts. We suggest eliminating this restriction if this legislation is passed by the Congress.

LIHC CARRYFORWARD RULE

Mr. Chairman, we understand that this provision is a very high priority of the Housing Credit Agencies, which have done a superb job of administering the Tax Credit. We are very supportive of this proposal and would defer to our friends at the National Council of State Housing Agencies for detailed comments on this issue.

PROPOSALS TO PERMIT TREASURY WAIVERS

We support the proposals that would allow the Treasury Department to waive penalties for de minimis errors in the application of tenant occupancy requirements and to waive annual recertifications of tenant incomes in 100% low-income buildings. With respect to the former proposal, we believe it is fair and sensible. As you are aware, the LIHC program is very complicated. As a property manager with a great deal of experience in this area, I believe my company is very proficient in following and applying the LIHC rules. However, inadvertent de minimis errors can occur, given the complexity of the program and human nature, and Treasury should be given discretion to waive penalties under these limited circumstances.

With respect to the latter proposal, we believe that it will reduce unnecessary paperwork. Many projects, particularly those

assisted by HUD and FmHA, have separate annual recordkeeping requirements which are necessary to determine subsidy levels. However, in 100% low-income buildings only assisted by the Tax Credit, there is no reason to recertify incomes of existing tenants because no penalties are applied to the owners or tenants even if incomes increase beyond the limits (provided new tenants meet the income limitations). Thus, the only necessary verification should occur upon initial occupancy; thereafter, recertifications amount to costly and unnecessary paperwork.

USE OF TAX-EXEMPT FINANCING WITH THE 70 PERCENT TAX CREDIT

As the Subcommittee is well aware, despite recent drops in interest rates, there continues to be a "credit crunch" throughout the country. Nowhere is it felt as severely as in the low-income housing sector. Developers, both non-profit and for-profit, unanimously agree that finding mortgage financing has become the single greatest impediment to the development of affordable housing. Savings and Loans and commercial banks are reluctant to lend on any real estate; loaning for low-income housing is virtually unthinkable (with the exception of the Federal Home Loan Banks' Affordable Housing Program, which can meet only a fraction of the overall need). With the demise of the FHA coinsurance program and the implementation of restrictions by HUD on Tax Credit properties, FHA-insured financing has ceased to address the need.

The Congress could help address this situation by allowing the use of the 70 percent credit with financing provided by tax-exempt bond proceeds. Under present law, the use of tax-exempt bonds restricts a project to the 30 percent credit and has resulted in very little utilization of such bonds in credit eligible projects because, quite simply, the "numbers" do not work. If this restriction were removed or modified, bond financed credit properties would become feasible and such financing could begin to fill a very critical need for mortgage debt.

USE OF THE LIHC BY BUYER OR SELLER IN YEAR OF TRANSFER

Although we have not examined legislation dealing with the use of the Tax Credit during the year a project is disposed, we assume that this issue arises from the statement in the General Explanation of the Tax Reform Act of 1986 (the "Blue Book") that in the year of a recapture event, no credit is allowable for the taxpayer subject to recapture. As discussed below, we do not believe recapture should occur simply because of the transfer of a property in compliance with the Tax Credit rules or a partnership interest therein. Accordingly, both the buyer and seller of a property should be able to use the Tax Credit pro-rated, as under present law, by application of a mid-month convention for the month of transfer.

OTHER PROPOSALS

Mr. Chairman, we would also like to include for the record a brief discussion of other issues which are important to our members.

Need to Modify Rent Rules

In 1989 the Congress changed the manner by which rents were determined by requiring that rents be figured on the basis of the number of bedrooms in a unit, not by the number of occupants. This change was fairer for both tenants and owners and provided predictability when underwriting Tax Credit projects. However, the change was made only for projects receiving allocations in 1990 and thereafter.

A persistent problem for owners and managers of these properties is the confusion caused by the different rent rules which apply for projects depending on when they received an allocation. These new rules, which Congress determined to be more appropriate, should be applied to projects which received 1987-1989 credit allocations. In order to assure that no tenant would be burdened by this change, this change should be effected only upon the vacancy of a unit. We are pleased that the Committee included this amendment in its version of H.R. 11 last year and that the Senate included it in its version of the Budget Reconciliation bill. We hope the conference will adopt this important provision.

In addition, under the Section 515 rural rental housing program, the Farmers Home Administration requires the collection of rents which are the higher of the (i) "basic rent" (based on payment of the FmHA 1% interest rate note, the required operating and maintenance expenses, and an 8% return on the owner's 3% equity in the project) or (ii) 30% of the tenant's adjusted income.

A problem occurs when the Tax Credit allowable rents are lower than the FmHA calculated rents. (This problem takes place if there is a decrease in median incomes, which has occurred in over 15% of the country in 1993 or if the tenant's income rises.) In such cases, the owner must make up the difference between the allowed Tax Credit rent and the required FmHA rent. Rental assistance (RA), the FmHA subsidy which makes up the difference between 30% of a tenant's income and the FmHA calculated required basic rent, does not count towards a tenant's actual rental payment for purposes of the Tax Credit; i.e., the owner is permitted to collect RA in addition to the tenant's payment (if the tenant payment is within Tax Credit limits). However, RA is not always available. In addition, where 30% of an RA tenant's income is more than the Tax Credit restricted rent, the owner must make up the difference between the Tax Credit rent and 30% of the resident's income (up to the point where the rental assistance kicks in).

In 1990, Congress addressed a portion of this issue, effective for properties receiving Tax Credit allocations after 1990. The Code now permits the owner to collect from the tenant the amount above the "basic" rent to the extent that the owner must pay that amount as "overage" to FmHA, even if the tenant's payment exceeds the otherwise applicable Tax Credit rent. We strongly believe that this rule should be made effective for properties receiving pre-1991 allocations. Moreover, if the Tax Credit rent falls below the basic rent, due to a decrease in area median income, the existing provision (even for post-1990 properties) does not allow the owner to collect from the tenant the difference between the Tax Credit rent and basic rent. The owner is required to make up that difference. For example, if the Tax Credit rent is $250 per month, and the basic rent is $275, the owner must pay FmHA $25, which cannot be collected from the tenant because of the existing Tax Credit limit. As another example, if the Tax Credit rent is $250, basic rent $275 and 30% of the tenant's income equals $290, present law would permit the owner to collect an additional $15 from the tenant ($290 minus $275) because that must be paid as overage to FmHA, but the owner would be required to pay $25 ($275 minus $250) out of its own pocket because only amounts over the basic rent are considered overage but FmHA requires payment of the full amount (basic rent and overage).

We propose that commencing after the first year of the credit period, owners should be allowed to collect the full FmHA required rents without being in violation of the Tax Credit requirements. By allowing this to occur only beginning in the second year, Congress would ensure that properties were renting

to Tax Credit eligible residents at Tax Credit restricted rents when they are initially placed in service. This change would also help simplify the needlessly complicated interplay between the Tax Credit and FmHA rent rules.

Need for Additional Sources of Equity Capital

There are certain restrictions now in the Code which hinder the raising of equity financing for Tax Credit eligible properties. If left unchanged, these provisions could jeopardize our future ability to raise sufficient capital to finance all the housing that will receive the Credit. Of course, the enactment of a permanent extension would have a very positive impact on our ability to raise funds. However, we believe that the Congress could further help the situation in two important ways.

First, the Congress should pass legislation which would modify the passive loss rules to allow the use of approximately $20,000 in low-income and rehabilitation credits against taxes on non-passive income. A number of investors have told equity syndicators that they would welcome the opportunity to invest more capital in credit projects but for the limit of approximately $7,000 in credit usable against taxes on non-passive income. Furthermore, other higher income individuals have said that a $7,000 credit is just not worth the time and energy it takes to understand the investment.

Most in the equity capital industry are finding it increasingly difficult to locate individual investors interested in this program. The present limit makes it impossible to attract many individuals who have already invested and it discourages other higher income investors. Raising the limit to approximately $20,000 would free up this badly needed capital and would help assure a steady flow of equity to credit eligible projects in coming years.

However, raising the limit alone is not sufficient. Even more importantly, the Code should be amended to permit the credit to be used against the Alternative Minimum Tax.

We have examined an analysis concerning the impact on Low-Income Housing Tax Credit investment of the current Alternative Minimum Tax ("AMT") as well as the revised AMT proposed by the Clinton Administration and embodied in the pending Budget Reconciliation legislation.

The analysis demonstrates that, except for very wealthy taxpayers, because of current or proposed AMT restrictions, virtually no investors are able to fully utilize $7,000 in Low-Income Housing Credits which would otherwise be available under the special exception to the passive loss rules for such Credits. (Code Section 469(i) allows a $25,000 deduction equivalent against income from any source for Low Income Housing and Rehabilitation Credits, which equates to $7,750 in Credits at the 31% bracket and $7,000 at the 28% bracket.) As the analysis demonstrates, under present law, because of AMT limits, taxpayers are unable to utilize currently as much as $4,509 of the $7,000 they would have had otherwise available. Similarly, under the proposed rates, up to $4,109 could not be taken.

The analysis is based on hypothetical taxpayers and makes certain assumptions as to income and deduction amounts. While the hypothetical will not, of course, be applicable to all taxpayers, we believe that it represents a fairly typical case and that almost all taxpayers will be severely limited in the amount of credits that can be utilized because of the AMT.

This situation creates at least three problems. First, by limiting the amount of Tax Credits which individuals can utilize, the amount of capital which new investors will contribute is

greatly reduced. The result is that less equity is available for projects being developed and less units are produced. Second, those who have already invested once and who may be very pleased with their decision are unlikely to invest additional funds because of the AMT. Third, existing investors, who believed that Congress would not again retroactively deny their benefits, have seen their Tax Credit utilization substantially eroded since the AMT rate was increased in 1990. It is not only unfair to penalize investors in this manner, but word of their frustration makes it even more difficult to raise capital from other investors.

We are proposing that a limited amount of Low-Income Housing and Historic Rehabilitation Credits be usable against the Alternative Minimum Tax. Specifically, we suggest that individuals be allowed to use these Credits to reduce AMT liability by up to 25 percent, to a maximum of $20,000.

Alternative to Recapture Bonds

The posting of a bond to avoid recapture of the Tax Credit contained in Section 42(j)(6) has not proved workable in practice. To our knowledge, there are no companies which are issuing such bonds, despite the repeated attempts by owners of Tax Credit projects to obtain them. Without an alternative mechanism, an owner or investor which transfers its interest, where the property still remains in compliance, will suffer recapture of prior credits taken.

The most practical solution would be to treat all partnerships as if they were subject to the rule in Section 42(j)(5), the "large" partnership rule. Moreover, the disposition of more than a fifty percent interest in the capital and profits in a twelve month period should not be treated in a different manner than the disposition of a less than fifty percent interest. We do not believe that a transfer of a property which is otherwise in compliance or a partnership interest should trigger recapture.

The result of this amendment will put the risk of recapture in the event of future noncompliance on the partners of the partnership which then owns the property, and on the new partner that purchases an old partner's interest. It is the partnership and then new partner that is in control of the property and can best keep the property in compliance. Moreover, if there is a greater risk which the new partner now bears, this can be a factor in the price to be paid for the partnership interest.

We would further propose that the seller of the property or the selling partner remain secondarily liable for payment of the recapture in the event that the buyer or new partner is unable to pay the recapture.

* * * * * * * * * * *

Thank you for the opportunity to provide this testimony. We would be happy to answer any questions or provide you with any additional information.

Chairman RANGEL. Let me thank the entire panel. And I do hope that you might consider just listing and forwarding to my office those legislative changes that you think could improve our housing laws.

We do have contact with people that serve on banking and other committees to see how we can improve the bill and try to work with each other. So we will hold on to your testimony. But if you could just list those areas that changes in the law could improve the package, that ultimately the Congress would give you various agencies to work with, it will help us and serve as a guide for us.

So we want to thank you for the contribution you made today. Also, I want to thank you for working with our committee as we try to fashion this legislation—the legislation in the manner which would allow you to do your jobs better and provide the shelter for people who so sorely need them.

[The following was subsequently received:]

1993 Legislative and Regulatory Program
Association of Local Housing Finance Agencies

The members of the Association of Local Housing Finance Agencies represent those local governments which have been most successful in pioneering new approaches to the delivery of affordable homeownership and rental housing for low- and moderate-income households in their respective communities. What was necessity during the Reagan and Bush Administrations can become an opportunity for partnership with the Clinton Administration and the new Congress. The recommendations outlined below, including tax code provisions as well as authorization and appropriations legislation, are based on the need for adequate funding of federal housing programs if such programs are to be effective in expanding housing opportunities and contributing to economic growth. The recommendations also reflect awareness of the continuing budget problems and the need to effectively utilize federal funding, leverage the private sector, and promote community and economic development.

Although Congress twice passed legislation to extend the June 30, 1992, "sunset" on the authority of housing finance agencies to issue tax-exempt Mortgage Revenue Bonds/Mortgage Credit Certificates (MRBs/MCCs) and allocate Low-Income Housing Tax Credits (LIHTCs), both bills were vetoed by the President. Permanent extension of both programs is thus unfinished business. Congress, however, did pass and the President signed legislation reauthorizing the HOME and Community Development Block Grant programs, containing many of the changes recommended by ALHFA. Congress also passed legislation providing FY 1993 funding for the HOME and CDBG programs.

With a new Administration taking office, led by a President committed to focusing on domestic policy, plus a new Congress, there is likely to be a receptive ear to ALHFA's legislative and regulatory recommendations set forth below.

Legislative Recommendations

TAX CODE PROVISIONS

- ★ Recommend that the President immediately ask Congress as its highest priority to pass legislation permanently extending the authority to issue tax-exempt Mortgage Revenue Bonds/Mortgage Credit Certificates and allocate Low-Income Housing Tax Credits, and that the President sign legislation immediately. Authority for these programs expired on June 30, 1992; without them, urgently needed affordable housing cannot be financed.

- ★ Recommend that Congress improve the workability of tax code incentives used to help stimulate provision of affordable housing by:

HOME AND CDBG AUTHORIZATION ISSUES

★ Recommend that Congress increase the flexibility and workability of the HOME and CDBG programs by:

- Replacing the two-tiered non-federal matching requirement with a uniform match of 25 percent, coupled with full credit for project-based, publicly issued single and multifamily debt used for HOME eligible projects. Such debt represents a real commitment of resources on the part of the issuing entity, no less so than other forms of match such as cash contributions.

- Modifying the automatic match waiver to eliminate the phased reduction. Communities should be able to qualify for a complete waiver if they meet either of two distress criteria: poverty or per capita income.

- Making several revisions to the use of HOME and CDBG funds for administrative costs:

  1. Clarifying that the 10 percent annual allowance for program administration applies to 100 percent of FY 1992 funds and years thereafter and remains available until expended; and

  2. Conforming the treatment of activity delivery costs under the HOME program to that of the CDBG program, *i.e.*, allowing them to be charged to the eligible activity with which they are associated.

- Conforming HOME's definition of Single Room Occupancy projects to that used in other federal programs such as the McKinney Homeless and Shelter Plus Care programs, thus allowing it to be used with funds from those programs.

- Modifying the Community Housing Development Organization (CHDO) set-aside to make a broader range of nonprofit housing development organizations eligible for funding, enabling participating jurisdictions to spend more time on developing these organizations' capacity to produce and manage housing and less on seeking out groups that meet narrow eligibility requirements.

- Modifying the CDBG eligible activity "housing services" by removing the requirement that they be subject to the administrative cap. Several of these activities, such as housing counseling, are not administrative activities, but housing-related services. Others, such as loan servicing, are administrative activities which are properly considered activity delivery costs of eligible activities and would not otherwise be subject to the cap.

- Modifying the CDBG program to increase from eight to twelve units the threshold for triggering Davis-Bacon prevailing wage rate requirements in order to conform it to HOME.

- Authorizing a loan guarantee program similar to the Section 108 program under CDBG. This would enable participating jurisdiction to draw against future entitlements in order to undertake large scale rental projects.

These recommendations are intended to make the HOME program more relevant to local communities. Given the present local government budget shortfalls, the current match requirement will impede the utilization of the HOME program. The underlying principle should be to leverage local and private investment, and this can be accomplished through more flexible match requirements. With limited budget resources it makes no sense to restrict the use of HOME [and CDBG] as financing reserves. More flexible usage in this respect would serve to expand the impact of these limited funds, while facilitating private investment in affordable housing.

APPROPRIATIONS

★ Urge the President to propose, and the Congress to pass, an economic stimulus FY 1993 supplemental appropriation of:

- $1.1 billion for HOME to bring it to its authorized level of $2.1 billion; and

- $2 billion for CDBG.

★ Recommend that Congress approve an FY 1994 funding level of $2.1 billion for the HOME program, the full authorization level.

★ Recommend that Congress approve an FY 1994 funding level of $5 [$4.2] billion for the CDBG program.

OTHER HOUSING AUTHORIZATION ISSUES

★ Recommend that Congress restore FHA's staffing level to its pre-Reagan Administration days to carry out the single and multifamily insurance programs.

★ Recommend that Congress authorize Fannie Mae to create a secondary market for purchasing construction loans for single-family housing (something savings and loan institutions did before their collapse), with the federal government providing a guarantee for a fixed amount of loss protection. A portion of the homes constructed must be set-aside for homebuyers meeting the eligibility requirements of the MRB program.

- ★ Recommend that Congress increase from 15 percent to 30 percent the amount of Section 8 rental assistance which can be project-based. This income stream would facilitate obtaining debt financing to increase the stock of affordable housing.

- ★ Recommend that Congress amend the GSE legislation to permit Fannie Mae to receive credit toward meeting the 30 percent annual housing goal for purchasing loans on multifamily housing projects which meet the pre-1986 Tax Act targeting requirements (*i.e.*, at least 20 percent of the units set-aside for those at 80 percent of median income or less) as long as the regulatory agreement is extended for an additional 10 years. Currently, credit is given only to mortgage purchases where the targeting is 20 percent at 50 percent of median or 40 percent at 60 percent of median income.

- ★ Recommend that Congress directly address the credit crisis by modifying FIRREA's multifamily risk-based capital standards applicable to lending institutions, treating multifamily loans for projects of 36 units or more which meet the targeting requirements of the Low-Income Housing Tax Credit the same as single-family loans rather than 100 percent higher (*i.e.*, 8 percent rather than 4 percent), so that lenders can resume making multifamily mortgage loans for low- and moderate-income housing.

- ★ Recommend that Congress rewrite the HOPE I, II, and III programs and consolidate them into a single funding source, with a uniform 25 percent non-federal match, available to public housing authorities, managers of subsidized housing projects, nonprofits, resident management corporations, and local governments to develop homeownership programs for their tenants without dictating program design or forcing the sale of units from the public housing or assisted housing stock.

The federal government can do much to encourage, or stifle, private financing of affordable housing. FIRREA, adopted in the midst of the massive savings and loan crisis, both mandates investment in affordable housing, and at the same time inhibits such investment. Reform of the currently unfocused regulatory constraints on even prudent lending, as well as positive federal credit support, can contribute to a reinvigoration of investment in affordable housing without entailing large budget expenditures.

Regulatory Recommendations

- ★ Urge HUD to increase the flexibility and reduce the regulatory burden for the HOME Program by:

    - Eliminating the regulatory provisions which require communities to seek a waiver of the 203(b) cost limit on the use of HOME funds for homeownership or rehabilitation, permitting them instead to use the 95 percent of average area purchase price limitation permitted by statute.

- Removing the penalty which reduces the value of the Low-Income Housing Tax Credit from 9 percent to 4 percent when used with HOME funds or tax-exempt bonds, as there is ample safeguard under current law to prevent over-subsidization of a project. Most rental housing projects require multiple subsidy sources; the current reduction is arbitrary.

- Clarifying that shared appreciation/subsidy lien second mortgage programs used in tandem with MRBs do not constitute an ownership interest on the part of the issuer, are excluded from the acquisition cost limits of the program, and have no effect on the "effective rate of interest" on first mortgage loans financed from an MRB issue.

- Increasing the ceiling on MRB-financed home improvement loans from $15,000 to $25,000 in order to make it consistent with the limitation in the FHA home improvement insurance program and to reflect the increased cost of improving older homes since this limit was put in place.

- Redefining the term "target area" in the MRB program (wherein higher income limits are permitted) to include census tracts where 50 percent of the households have incomes below 90 percent of the area median (rather than the 70 below 80 currently). This will promote neighborhood stability by permitting moderate- and middle-income households to locate or remain in central cities.

- Extending the 42-month origination period for MRB-financed loans to 60 months to allow more time to originate these very labor-intensive loans.

- Permitting MRBs to finance new construction of up to four units, with current law targeting applying to occupants of all the units financed.

- Eliminating the Alternative Minimum Tax from tax-exempt single and multifamily housing bonds. The tax does not raise revenue, and it adds an average of 25 basis points in additional cost to issuers.

- Restoring the deductibility of carrying costs of bank purchases of tax-exempt bonds when the proceeds of such bonds are utilized to fund mortgages in census tracts where at least 50 percent of the households have incomes below 90 percent of the median income.

Tax-exempt mortgage bond financing has been the main tool utilized by local and state housing finance agencies in financing low- and moderate-income housing and fostering partnerships with the private and nonprofit sectors. The recommendations made here would continue the availability of this tool for ownership housing, extend the tax credit as an investment incentive for rental housing, and strengthen the capability of MRBs to assist in inner city investment.

- Eliminating the regulatory requirement that a construction financing commitment be in place before land is acquired with HOME funds for a HOME-assisted project.

- Extending from six months to twelve months the regulatory requirement prohibiting the lending of HOME funds for projects which cannot be under construction within that time frame.

- Clarifying that, in the event that a project which a participating jurisdiction funds falls out of compliance with the requirements of HOME, the jurisdiction shall first seek to return the project to compliance, then if necessary make reasonable efforts to see that the project developer repays the HOME subsidy; but in the event that the developer cannot, the jurisdiction shall not be required to repay such subsidy to its HOME trust fund or to HUD.

★ Urge HUD to expeditiously implement the multifamily mortgage insurance risk sharing program between FHA and state and local housing finance agencies, authorized by the Housing and Community Development Act of 1992, and ensure that local agencies have maximum opportunity to participate.

Adopted by the ALHFA Board, January 28, 1993

Chairman RANGEL. Panel three is Harry K. Schwartz, director of public policy, National Trust for Historic Preservation; Nellie Longsworth, president, Preservation Action; Terry Lewis, president, National Assistant Management Association; and John Hood, vice president, Volunteers of America.

Your entire statements, of course, as with other witnesses, will be entered into the record by unanimous consent. You can highlight or take your 5 minutes in any manner that you think you feel comfortable with in presenting your views to the committee.

We will start off with Harry Schwartz.

STATEMENT OF HARRY K. SCHWARTZ, DIRECTOR, CENTER FOR PRESERVATION POLICY STUDIES, NATIONAL TRUST FOR HISTORIC PRESERVATION

Mr. SCHWARTZ. Mr. Chairman, thank you very much.

It is an honor to be able to present testimony before this distinguished subcommittee on behalf of the National Trust for Historic Preservation. As I am sure the panel knows, the National Trust was chartered by an Act of Congress. It is a private nonprofit organization, with 250,000 members.

Mr. Chairman, I have a statement signed by 34 organizations in support of H.R. 1406, which I would like to have also included in the record along with our prepared statement, if I may?

Chairman RANGEL. Without objection.

Mr. SCHWARTZ. Thank you very much, sir.

We are here today because of our commitment to saving America's cities. We believe that the goals of our urban policy should include preserving the heritage and values of America's older cities and maintaining the investment we have made in our older cities and neighborhoods.

These goals are not new. They are, in fact, word for word, the goals set forth in the National Urban Policy promulgated by the Carter administration in 1978.

Mr. Chairman, we do not need to reformulate our goals and we do not need to reinvent the tools to achieve them. They exist. We have used them before and they have worked. They can, and they must, be made to work again.

One of the most successful tools has been the Historic Rehabilitation Tax Credit. This program has channeled over $16 billion in private investment into the rehabilitation of older and historic buildings since it was initiated in 1978.

This is not an elitist program. It is a program which has helped to save cities, to provide affordable housing, and to create jobs.

It has given us Union Station in Washington, D.C., but it has also given us a revitalized warehouse district in New Orleans and has helped rescue an abandoned paper mill, which was a haven for drug users and arsonists, in Appleton, Wis.

It has provided over 21,000 units of housing in historic buildings. It has helped change the face of our cities and it has helped make our communities more livable.

All of us know that the one essential ingredient of any program to save our cities is jobs. We have to create jobs with dignity, jobs with a future, not just jobs as hamburger flippers. And once again, the rehab credit provides the answer.

Invest a billion public dollars in highway construction and you get 52,000 jobs. Invest a billion dollars in the rehab tax credit and you get 175,000 jobs. And these are skilled jobs which can provide satisfying and remunerative careers for inner-city residents.

I think that many Members of this body would admit that Congress went too far in 1986 when it subjected the rehab tax credit to the "passive loss" rules and the income caps. I do not believe that Congress intended to eviscerate this very successful program so that the level of investment generated in 1992 was down to 20 percent of the 1985 level.

H.R. 1406 was introduced to get the program up and running again. It would treat all investors alike by deleting the income test. And although it would not remove the "passive loss" restrictions entirely, it would permit an individual taxpayer to take up to $20,000 per year in tax benefits instead of approximately $7,000 as permitted by present law.

Mr. Chairman, this credit is not just about bricks and mortar, although it will help to renew our neighborhoods and revive our downtowns and main streets. It is not just about jobs and economic stimulus, although it will create many jobs, quality jobs, and will help revive our flagging economy.

It is about community pride and heritage. It reflects our national commitment to the preservation of our diverse culture through the protection and restoration of treasured places, treasured in our individual, personal memories, and treasured in our shared history.

The past is part of us. We owe it to our children and our children's children to do what we can to save it. What we can do, and what we urge you to do, is to approve H.R. 1406.

Thank you very much, sir.

Chairman RANGEL. Thank you, Mr. Schwartz.

[The prepared statement and attachment follow:]

NATIONAL TRUST FOR HISTORIC PRESERVATION

1785 Massachusetts Avenue, N.W.
Washington, D.C. 20036
(202) 673-4000/FAX (202) 673-4038

Statement of

Harry K. Schwartz
Director
Center for Preservation Policy Studies
National Trust for Historic Preservation
before the
Subcommittee on Select Revenue Measures
Committee on Ways and Means
United States House of Representatives

July 13, 1993

Mr. Chairman, I am pleased to have this opportunity to testify on behalf of the National Trust for Historic Preservation in support of H.R. 1406, the Community Revitalization Tax Act of 1993. The National Trust is a private non-profit organization with a quarter of a million members chartered by Act of Congress in 1949. Its mission is to foster an appreciation of the diverse character and meaning of our American cultural heritage and to preserve and revitalize the livability of our communities by leading the nation in saving America's historic environments.

We are here today because of our commitment to saving America's cities. We believe that the goals of our urban policy should include preserving the heritage and values of America's older cities, and maintaining the enormous investment that we have made, in both the public and private sectors, in older cities and their neighborhoods.

These goals are not new. They are, in fact, word for word, the goals set forth in the National Urban Policy promulgated by the Carter Administration in 1978.

Not only have we already formulated the goals of our urban policy; we have also designed some of the key tools needed to achieve those goals. One of the most successful has been the Historic Rehabilitation Tax Credit.

First enacted in 1978, this credit has channelled over $16 billion in private investment into over 25,000 preservation projects. These range in scale from Union Station, in Washington, D.C., to the Fox River Mills-- a mixed use project what was once a derelict paper mill in Appleton, Wisconsin-- to the Rosa True School, an eight-unit low/moderate income rental project in a historic school building in Portland, Maine.

The 1986 Changes in the Credit

Unfortunately, changes in the Federal Income Tax Code enacted in 1986 have eviscerated this highly successful program. These changes subjected the Historic Rehabilitation Tax Credit to the "passive loss" rules, providing an annual allowance per individual taxpayer of only approximately $7,000 from the passive loss limitations. In addition, the 1986 changes made the credit unavailable to those individual taxpayers with the greatest financial capacity to make use of them: those with adjusted gross incomes over $250,000.

Since 1986, use of the Historic Rehabilitation Tax Credit has dropped off dramatically. In 1985, estimated investment in historic rehab tax credit projects was $2.4 billion; in 1992, in was $491 million, representing an 80 percent drop.

How H.R. 1406 Would Help

H.R. 1406 would correct the damaging changes made in the credit in 1986 in two important ways: it would completely remove the income cap, permitting all taxpayers to participate in the program without regard to their income; and it could increase the amount of tax benefit an individual taxpayer could use without being subject to the passive loss rules in any year from $7,000 to $20,000. We believe that these changes would revitalize the credit, and encourage the flow of private investment capital into neighborhood and historic preservation and renewal projects.

Restoring the Historic Rehabilitation Tax Credit in this way would provide a stimulus to our sluggish economy, conserve precious resources in community infrastructure, create large numbers of quality jobs for the federal dollars invested, expand our supply of badly-needed affordable housing, revitalize neighborhoods and address the most urgent need of the urban agenda-- the need to give hope to inner city residents.

Let me address, briefly, each of these benefits that would flow from a revived historic rehab credit.

Immediate Economic Stimulus

Restoration of the Historic Rehabilitation Tax Credit will have an immediate beneficial economic impact. It will not require new implementing regulations or other governmental actions to take effect. Once the legislation is enacted, businessmen will immediately begin to raise capital for an existing backlog of rehabilitation projects and move quickly to hire workers to begin work on these projects.

Create More and Better Jobs for the Federal Dollar

According to Congressional sources, every $1 billion spent on highway construction generates 52,000 jobs. But because rehabilitation is very labor intensive and because of the five-to-one leverage yielded by the 20 percent rehab tax credit, an analysis of Commerce Department data shows that every $1 billion invested in Historic Rehabilitation Tax Credits yields 175,000 jobs. In addition, an analysis of Department of Commerce data shows that every $1 million invested in rehabilitation creates five more construction jobs, and, because of the multiplier effect of the additional construction jobs, three more permanent jobs than the same amount invested in new construction. The higher number of jobs created is a direct result of the higher portion of total expenditures going to labor. Moreover, this kind of work offers job-training opportunities for unemployed young people, gives them a stake in the community and provides them with a chance to develop long-term, high-earning skills.

Urban Revitalization

Because most of the properties eligible for the Historic Rehabilitation Tax Credit are located in urban areas, restoration of the credit will necessarily target resources to urban revitalization. During the 1980's, the rehabilitation of older and historic structures became a central element in many communities' overall economic development strategies. A 1987 study by the National League of Cities asked economic development professionals to identify which cities were most successful in economic development. Of the twenty cities named, fifteen were also among the most active in using the rehabilitation tax credits. Surveyed four years later by the National Trust for

Historic Preservation, 94 percent of those same economic development officials identified the 1986 changes in the tax code as the major reason for the decline in rehabilitation activity in their communities.

Affordable Housing

Historic preservation has a strong track record in providing affordable housing. Over 21,000 units of low- and moderate-income housing have been created in historic rehabilitation projects since 1977, according to a National Park Service report. While the 1986 Tax Act has greatly reduced the amount of rehabilitation activity, housing has consistently remained the most common use of historic projects nationwide.

Conserving Resources

Historic preservation conserves resources. A recent Rutgers University study found that preserving cities and containing sprawl could save the State of New Jersey about $1.3 billion in capital infrastructure costs and 30,000 acres of prime farmland by the year 2010. This is consistent with studies assembled by the Urban Land Institute that indicated that such sprawl had lifetime costs of 40 percent to 400 percent greater than compact development. By reviving cities and avoiding sprawl, preservation reduces automobile commuting, enhances air quality and saves workers commuting time. It also conserves our nation's heritage of farmland, forests, wetlands, historic battlefields, scenic vistas and recreation areas that are being consumed while our built environment is subject to abandonment and decay.

Small Business Development

Small businesses have been active beneficiaries of the Historic Rehabilitation Tax Credit. IRS data show that this has been in large part a "mom and pop" program. Between 1982 and 1986, 31 percent of all tax credit projects were done by individuals with adjusted gross incomes of less than $30,000; 50 percent had incomes of less than $50,000. Furthermore, 48 percent of historic rehabilitation projects totalled less than $100,000; 80 percent less than $500,000. Equally important, contractors performing work on these projects have tended to be small entrepreneurs and craftsmen.

Building Community Spirit

When a neighborhood is saved and renewed, instead of left to deteriorate, its residents develop pride in the community. This has happened in the historic, largely black, Springfield neighborhood in Jacksonville, Florida. Local residents have restored old houses and revived faltering businesses. Notably, there was a 39 percent decrease in violent crime reported in one year following these improvements.

* * *

Mr. Chairman, the time for action on our urban agenda is now, and the path is clear. In H.R. 1406 and its Senate companion bill, we have at hand a key component of a successful urban strategy-- one that has worked in the past, and can work again. Its support is bipartisan and broad; seventy-nine members of both bodies, Democrats and Republicans alike, have joined as cosponsors. We urge that you report it favorably, and that you press forward to achieve its enactment in the current session.

Joint Statement in Support of H.R. 1406,
The Community Revitalization Tax Act of 1993

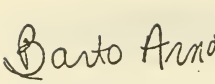
We support restoration of the Historic Rehabilitation Tax Credit.

First enacted in 1978, this credit has been one of our most effective and successful urban revitalization tools. It has channelled over $16 billion in private investment into some 25,000 preservation projects. Over 21,000 units of affordable housing have been created in historic rehabilitation projects. By conserving and reusing older buildings, the credit has helped to reduce energy consumption and pollution, giving new life to older neighborhoods and downtowns and preserving open space.

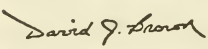
Unfortunately, changes in the tax code enacted in 1986 have crippled this vital program. The amount of investment generated by the credit in 1992 was one-fifth of its 1985 level.

Legislation to rectify this situation has been introduced with broad cosponsorship in both the House of Representatives and the Senate. Both H.R. 1406, introduced by Representatives Kennelly, Shaw, Andrews, Matsui and Gephardt, and S. 895, introduced by Senators Pryor, Danforth and Boren, would reactivate the Historic Rehabilitation Tax Credit.

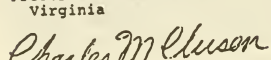
Passage of this legislation can help create badly needed jobs, revitalize our communities and preserve our priceless heritage. We urge its prompt enactment.



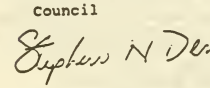
Barto Arnold
President
Society for Historical
Archaeology



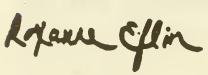
David J. Brown
Executive Director
Preservation Alliance of
Virginia



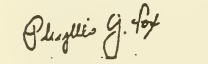
Charles M. Clusen
Senior Associate
Natural Resources Defense
Council



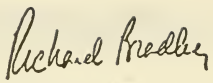
Stephen Dennis
Director
National Center for
Preservation Law



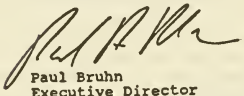
Roxanne Eflin
President
Colorado Preservation, Inc



Phyllis G. Fox
President
Historic Hawai'i Foundation

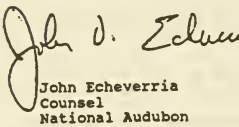


Richard Bradley
President
International Downtown
Association

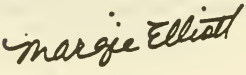


Paul Bruhn
Executive Director
Preservation Trust of Vermont

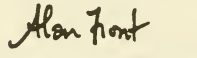
Arijit De
Chairman
New Jersey Historic Trust



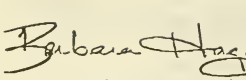
John Echeverria
Counsel
National Audubon
Society



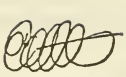
Margie C. Elliot
Executive Director
Preservation Texas, Inc.



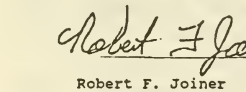
Alan Front
Vice-President
Federal Affairs
Trust for Public Land



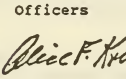
Barbara Hagan-Smith
Director
St. Croix Landmarks Society



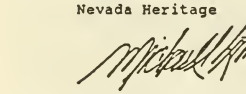
Eric Hertfelder
Executive Director
National Conference of State Historic Preservation Officers



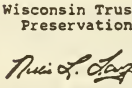
Robert F. Joiner
President
Nevada Heritage



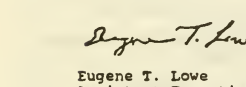
Alice F. Krueger
President
Wisconsin Trust for Historic Preservation



Michael Leventhal
Executive Director
Utah Heritage Foundation

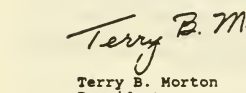


Nellie Longsworth
President
Preservation Action

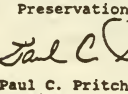


Eugene T. Lowe
Assistant Executive Director
U.S. Conference of Mayors

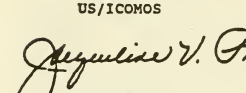
Richard Moe
President
National Trust for Historic Preservation



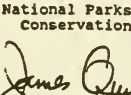
Terry B. Morton
President
US/ICOMOS



Paul C. Pritchard
President
National Parks and Conservation Association



Jacqueline V. Prior
President
D.C. Preservation League



James Quinn
Executive Director
Historic South Dakota

Ellen Sievert
President
Montana Preservation Alliance

Donald Slesnick
President, Board of Trustees
Florida Trust for Historic Preservation

Israel Stollman
Executive Director
American Planning Association

Harley N. Trice, II
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Preservation Pennsylvania

Carol S. Wyant
Executive Director
Landmarks Preservation Council of Illinois

Maitland Sharpe
Executive Director
Izaak Walton League

Bruce D. Smith
President
Society for American Archaeology

Clark Strickland
President
Preservation League of New York State

J. Reid Williamson, Jr.
President/CEO
Historic Landmarks Foundation of Indiana

Virginia Voorhees Wilcox
Interim Director
Washington Trust for Historic Preservation

TESTIMONY OF HARRY K. SCHWARTZ, DIRECTOR, CENTER FOR PRESERVATION POLICY STUDIES, NATIONAL TRUST FOR HISTORIC PRESERVATION

We are here today because of our commitment to saving America's cities. We believe that the goals of our urban policy should include preserving the heritage and values of America's older cities, and maintaining the investment we have made in our older cities and neighborhoods.

These goals are not new. They are, in fact, word for word, the goals set forth in the National Urban Policy promulgated by the Carter Administration in 1978.

Mr. Chairman, we do not need to reformulate our goals, and we do not need to reinvent the tools to achieve them. They exist. We have used them before, and they have worked. They can and must be made to work again.

One of the most successful tools has been the Historic Rehabilitation Tax Credit. This program has channelled over $16 billion in private investment into the rehabilitation of older and historic buildings since it was initiated in 1978.

This is not an elitist program. It is a program which has helped to save cities, provide affordable housing and create jobs. It has given us Union Station in Washington, D.C., but it has also given us a revitalized warehouse district in New Orleans and helped rescue an abandoned paper mill-- a haven for drug users and arsonists-- in Appleton, Wisconsin. It has provided 21,000 units of affordable housing in historic buildings. It has helped change the face of our cities. And it has helped make our communities more liveable.

All of us know that the one essential ingredient of any program to save our cities is jobs. We have to create jobs with dignity, jobs with a future-- not just jobs as hamburger flippers. And once again, the rehab credit provides the answer. Invest a billion public dollars in highway construction and you get 52,000 jobs. Invest a billion dollars in the rehab tax credit and you get 175,000 jobs. And these are skilled jobs which can provide satisfying and remunerative careers for inner city residents.

I think that many members of this body would admit that Congress went too far in 1986 when it subjected the rehab tax credit to the "passive loss" rules and the income caps. I do not believe that Congress intended to eviscerate this very successful program, so that the level of investment generated in 1992 was down to 20 percent of the 1985 level.

H.R. 1406 was introduced to get the program up and running again. It would treat all investors alike by deleting the income test. And although it would not remove the "passive loss" restrictions entirely, it would permit an individual taxpayer to

take up to $20,000 per year in tax benefits, instead of approximately $7,000 as permitted by present law.

Mr. Chairman, this credit is not just about bricks and mortar, although it will help renew our neighborhoods and revive our downtowns and main streets. It is not just about jobs and economic stimulus, although it will create many jobs--quality jobs-- and will help revive our flagging economy.

It is about community pride and heritage. It reflects our national commitment to the preservation of our diverse culture through the protection and restoration of treasured places-- treasured in our individual, personal memories, and treasured in our shared history.

The past is part of us. We owe it to children, and our children's children, to do what we can to save it. What we can do -- what we urge you to do -- is approve H.R. 1406.

Chairman RANGEL. Ms. Longsworth.

STATEMENT OF NELLIE L. LONGSWORTH, PRESIDENT, PRESERVATION ACTION

Ms. LONGSWORTH. Thank you very much, Mr. Chairman. It is an honor to be here today.

I am Nellie Longsworth, president of Preservation Action, the national grassroots lobby for historic preservation and neighborhood conservation. We represent over 1,000 historic preservation organizations, corporations and people concerned throughout the Nation, most of whom are professionals in the field.

Preservation professionals perceive their responsibility as broader than the operation of historic museums and assistance to the owners of historic houses. I should add that many were anxious to be a Preservation Action's witness today, including Laurie Beckelman from the New York Landmarks Commission. Since this was the commission's meeting day, she was not able to do it.

For 30 years, preservationists have rallied to protest a bias in the Federal Government that favors new construction over the rehabilitation of existing structures. The bias has shown up in the Tax Code, in agency regulations—we have just learned of one that requires a higher income level for tenants in existing structures to qualify for assistance than those in new housing—and in proposals such as enterprise zones and empowerment zones, which among their incentives does not specifically mention preservation/rehab for preferential tax treatment.

My personal involvement in preservation dates to 1976 and includes advocacy for the 1981 Economic Recovery Act Rehab Credit Program and the fight to spare the rehab credits from the 1986 Tax Reform Act. I was present at a memorable hearing in 1985 when Chairman Rostenkowski, familiar with the historic credit in his own Chicago district, said about the credit: "If it ain't broke, don't fix it."

Well, "it got broke." It got broke by actions taken in 1986 to close shelters in the Tax Code through restrictions in the use of the "passive loss" rules. In short, one of our Nation's most successful revitalization tools was eviscerated by passive loss rule changes and no longer attracts developers and contractors to the tough jobs of revitalizing our urban centers.

Developers who were doing historic rehab in the mid-1980s in blighted neighborhoods have not left the field. They have gone to the suburbs building malls, schools and market-rate housing.

Preservation Action is here today to testify in support of H.R. 1406 and its provisions. The rationale of these provisions is to attract private investors back into downtown as an option for their investment.

The increase in up-front credit is needed to attract money for the debt side of financing. Many agree that equity, particularly when the rehab credit is used in conjunction with the low-income housing credit, is not a problem. But they confirm that the ability to fill the gap between equity and debt is the hard part and often it is the bottom line which will encourage a developer to forgo an inner-city project. A removal of income caps will increase the equity capital available for private investor.

Harry has talked about jobs. That is very important. H.R. 1406 is needed to get on with the rehabilitation needs of a tremendous supply of underutilized and abandoned historic buildings existing in every older town and city throughout the Nation. They are located where infrastructure is already in place.

This infrastructure fact is important. Where it exists, it eliminates the cost of constructing and maintaining new roads, sewers and schools that will not be a cost to the developer, but will be paid for by State and local governments, who, in turn, will pass the costs on to the taxpayer. The improvement that returns safe and decent living conditions to the central city will save untold farmland and temper conditions which have led to spiraled and unbridled development.

Some legislators have suggested in light of the current and hopefully temporary budget crisis, we reduce revenue loss from our provisions by placing income restrictions on credit use, to include only National Registered districts that fall into census tracts where income is 80 percent of median area income. Some have called to limit the historic rehab credit use to affordable housing only. The preservation community, through Preservation Action's network, is studying such ideas to measure their impact on small town main street programs as to whether they would still be able to take benefit from this.

I have included a number of suggestions that have been brought to the attention of our organization and want it noted on the record that these suggestions are not official positions. However, I would like to end my testimony by turning to a report from Shlaes & Co., that was done in 1986, and it was done about the State of Illinois.

I know that Illinois is a State that this committee often likes to hear about. From 1981 to 1984 the tax credits were used in a total of 141 certified rehabilitation projects in the State of Illinois. These projects created 16,106 jobs, and they represented total private investment of $323 million. The effect on the Illinois gross output was $1,124,000, and the State tax revenues generated were $29 million, local tax, $32 million just by the use of these credits. I would like to put the report in your hands for the record because one of the conclusions is that when we include the tax of sale of property, personal income tax and corporate tax, the tax loss to the Federal Treasury is about 12 cents on the dollar, not the full 100 cents.

I thank you very much for this opportunity to testify.

[The prepared statement and attachment follow:]

PRESERVATION
Action

TESTIMONY OF NELLIE L. LONGSWORTH
PRESIDENT OF PRESERVATION ACTION
BEFORE THE SUBCOMMITTEE ON SELECT REVENUE MEASURES
JULY 13, 1993

Mr. Chairman and members of the Committee:

I am Nellie L. Longsworth, President of Preservation Action, the national grassroots lobby for historic preservation and neighborhood conservation. Preservation Action represents over 1,000 historic preservation professionals throughout the nation, many of whom are the directors of local preservation organizations in cities of all sizes, ranging from New York to Savannah, GA and including rural communities such as Georgetown, CO. All perceive their responsibility as broader than the operation of historic museums and assistance to the owners of historic houses. I should add that many were anxious to be Preservation Action's witness today but were unable to juggle schedules on just a week's notice of this hearing.

For thirty years, preservationists have rallied to protest a bias in the federal government that favors new construction over the rehabilitation of existing structures. The bias has shown up in the Tax Code, in agency regulations (some of which require a higher income level for tenants in existing structures to qualify for assistance than those in new housing) and in proposals such as Enterprise Zones which, among its goodies, does not specifically mention preservation/rehab for preferential tax treatment.

The bias is exacerbated by a widely held perception among public officials that preservation costs are much higher than new construction. In cases where new construction undertaken on a lot beyond the city taxing authority is compared to acquisition of a building in inner city, the total costs per square foot will support the new construction argument. However, if acquisition costs are removed from the equation, preservation is generally less costly than new construction. Infrastructure should be taken into account, where appropriate, as a secondary requirement and cost factor of new construction.

The first breakthrough in the battle for incentives to attract investors to the rehab of historic buildings came in the 1976 Tax Reform Act. The amortization incentive became a 25% tax credit in the 1981 Economic Recovery Act, a credit that supported the rehab of historic structures that met the certification standards of the Secretary of Interior.

Preservation professionals saw a great opportunity in 1981 and, in conjunction with developers and contractors, began the task of revitalizing historic neighborhoods and commercial districts within the urban core for residents of all income levels. The preservation professional has since been a front line player on the local level, uniting preservation goals with the programs of local community development and housing authorities, with state and local building codes, and with the maze of regulations that control financing and lending policies.

The preservation community has always shared a commitment to affordable housing and it is often the preservationist who can envision the conversion of vacant, blighted commercial buildings - abandoned schools, warehouses, industrial sites - into viable answers for local housing needs. With almost two decades of experience with tax incentives under our belts, we can attest that the reversal of a neighborhood or section of main street requires a community wide approach and is most successful when private investment is reinforced by local government commitment to areas such as street improvement and CDBG assistance. The private sector initiates the "ripple effect" while the local government's involvement can target the work to the area of greatest need.

Historic rehab is a very complicated venture with a high degree of unpredictability. Many areas of our downtowns are historic and stable but there are also areas that are blighted and crime ridden, straining the limited resources of the community. There are many unknowns in bringing these communities "back"...unknowns that range from predicting the structural condition of buildings (a factor such as previous fire damage that only becomes apparent after restoration has

begun) to the ability/inability to get financing from the banking community to changing demographics and population shifts to current zoning restrictions. Without a strong historic rehabilitation incentive, many viable projects will go unfunded and the area will continue to deteriorate as many have done since 1986.

There are some very positive "knowns" that will regenerate investor confidence if the credits receive favorable treatment from this Congress this year. The credits were widely used during the late '70's and early '80's and have produced some significant statistics: $15 billion in private investment put 23,000 underused and abandoned structures back on the tax rolls. 120,000 housing units were created of which 21,600 were low and moderate income units.

My personal involvement in preservation dates to 1976 and includes advocacy of the 1981 Economic Recovery Act rehab credit program and the fight to spare the rehab credits from the axe of the 1986 Tax Reform Act. I was present at a memorable hearing in 1985 when Chairman Rostenkowski, familiar with historic rehab credit use in his own Chicago district, said about the historic credit, "If it ain't broke, don't fix it".

Well, "it got broke" - by actions taken in 1986 to close shelters in the tax code through restrictions in the use of the passive loss rules. Within 6 years, the National Park Service has accumulated data that show an 80% decline in the use of the historic credit, - from $2.4 billion in private investment in FY 85 to $418 million in FY 92. In short, one of our nation's most successful urban revitalization tools has been eviscerated by the passive loss rules and no longer attracts developers and contractors to the tough job in our urban centers. Developers who were doing historic rehab in the mid-'80's in blighted urban neighborhoods have not left the field, they've gone back to the suburbs, building malls, schools and market rate housing.

Preservation Action is here today to testify in support of HR 1406 and its provisions to:

- Raise the taxable income to $65,000, allowing an individual investor to take @$20,000 credit annually as opposed to the @$7,000 allowed under current law, and

- Eliminate the income caps imposed by passive loss rules.

The rationale for both these proposals is to attract private investors back into downtown as an option for investment. The increase in "up front" credit is needed to attract money for the debt side of financing. Many agree that equity, particularly when the rehab credit is used in conjunction with the low income credit, is not a problem. They further confirm that the ability to fill the "gap" between equity and debt is the hard part and the bottom line confirm whether developers will undertake a historic rehab or forego it. The removal of income caps will increase the equity capital available from private investors.

Preservation Action is keenly aware of the budget constraints that face the committee as well as the entire Congress at this time and would like to put another "spin" on HR 1406. HR 1406 is a "jobs bill," creating jobs and stimulating economic recovery in areas of the city and small towns that most need assistance. For each $1 billion invested in historic rehab, 175,000 jobs are created, more than three times the number of jobs created by highway programs. Historic rehab is more labor intensive than new construction and provides a training ground in the neighborhood for unemployed young people and those displaced from other careers to learn skills that are needed and valued on a long-term basis. In 1984, a study done by Shlaes & Co. in Illinois noted that new taxes generated from construction, materials, employment, and increased tax base actually reduced the loss to the Federal Treasury to $.12 per dollar of claimed tax credit.

HR 1406 is needed to get on with the rehabilitation needs of a tremendous supply of underutilized and abandoned historic buildings extant in every older town and city throughout the nation. They are located where infrastructure is in already place. This infrastructure fact is important - when it exists, it eliminates the costs of constructing and maintaining new roads, sewers and schools that will not be costs to the developer but will undertaken by state and local governments which in turn will pass on the costs to the taxpayer. The improvement that returns safe and decent living conditions to central city will save untold farmland and temper conditions which have led to sprawl and unbridled development.

Some members of Congress suggest that we look to programs in HUD to do the revitalization job. We answer that the rehab tax credit program is one of the most efficient programs in the federal government, operating with minimal federal administrative overhead. The required certification process is handled by a partnership between state historic preservation offices and National Park Service personnel in 5 regional offices and many have suggested that this process be streamlined even further.

Some legislators have suggested that, in light of the current, and hopefully temporary, budgetary crisis, we reduce revenue loss by placing income restrictions on credit use to include only National Register districts that fall into census tracts where income is 80% of median area income. Some call for a further limitation that the rehab credit be limited to affordable housing only. The preservation community through Preservation Action's nationwide network is studying the ideas to measure the impact on small town main streets should such a requirement be temporarily enacted.

Since there is no prospect of tax legislation on the Committee's agenda until fall, Preservation Action and its members look forward to working with the Committee and staff to investigate an even wider range of possibilities to get our inner cities back on the tax rolls.

Some suggestions that have been brought to our attention but are not the official position of the organization include:

- When the rehab credits are used with low income housing credits for affordable housing, eliminate the basis reduction, eliminate effect of passive loss rules completely and increase rehab credit to 25%.

- Change the substantial rehabilitation threshold from 100% of adjusted basis to a lower percentage, i.e. 50%. (This will eliminate additional and unnecessary costs of total rehab incurred just to fulfill this requirement.)

- Relax the 35% limit on non-profit and public use of the rehabilitated structures.

- In hardship cases where the interior of a historic building cannot be retained for housing or a use needed by the community and where the alternative to rehab is demolition, require the exterior only to meet the Secretary's Standards and limit the allowable credit to 10% total.

- Adjust Alternative Minimum Tax to lessen the effect on the individual investor.

- Develop a National Affordable Housing Policy that unites rehab tax credits, agency programs and Enterprise Zone proposals.

Preservation Action would like to make it very clear that we are going on record today to support the changes proposed in HR 1406 at this time. The suggestions to reduce the universe of rehab credit use are in the spirit of responding to national needs while under very tight fiscal restrictions. We look forward to the time when we will have convinced all members of this body of the "rightness" of the historic rehab credits as a national revitalization tool. A trip down the main streets of historic districts in Hartford, in Pittsburgh, in Portland, in Macon, in Seattle, in fact, on Main Streets in every member's district is a reminder that the private sector can be a powerful partner in making our older cities our best cities.

Shlaes&Co.

ECONOMIC BENEFITS FROM REHABILITATION OF HISTORIC BUILDINGS IN ILLINOIS

Final Report

EXECUTIVE SUMMARY

SUBMITTED TO

Preservation Services Section
Illinois Department of Conservation
East Washington Street
Springfield, Illinois

June 25, 1984

BY

SHLAES & CO.
405 North Wabash
Chicago, Illinois 60611

The Department of Conservation estimates that on average approximately 85% of all the buildings in National Register and locally designated districts in Illinois contribute to the historic character of the district. Approximately 25% to 30% of all structures within Illinois historic districts are subject to the allowance for depreciation. The percentage of depreciable structures in Cook County is estimated to be slightly higher, 35%, and slightly lower, 20% in downstate counties.

Although all buildings individually listed on the National Register of Historic Places are automatically significant, only a small percentage, 41% in Cook County and 25% downstate, are depreciable. There are 65 depreciable properties within Cook County and 101 properties downstate.

The number of contributing structures in locally designated historic districts is higher than in National Register districts. Locally designated districts also have a higher percentage of depreciable properties than is typical of National Register districts, and we estimate that 50% of the structures in already certified local districts are depreciable.

Our best estimate is that there are about 7,900 buildings in Illinois that can currently take advantage of the 25% investment tax credit for rehabilitation, plus an additional 2,375 depreciable buildings in potential future National Register nominations. There are thus about 10,275 combined current and future structures qualifying for the 25% investment tax credit.

NUMBER OF PROJECTS AND TOTAL REHABILITATION EXPENDITURES TO DATE

Since the advent of special investment tax credits for the rehabilitation of historic buildings in 1981, the Illinois Department of Conservation has reviewed and given final certification to 141 projects involving a total estimated rehabilitation expenditure of $323.4 million.

Approximately 85% of the total statewide expenditure, or $275.3 million, has occurred in Cook County. Of this, $274.0 million have been in the City of Chicago. Other counties benefiting substantially from the rehabilitation tax incentives include Peoria, $11.4 million or 3.5% of the total; Kane County, over $8.0 million, or 2.5%; Jo Daviess County, more than $7.9 million, or 2.5%; Sangamon County, $7.7 million, or 2.4%; and Adams County, $5.8 million, or 1.8%.

ECONOMIC IMPACT OF CERTIFIED REHABILITATION

Gross Output

Using standard multipliers compiled by the Bureau of Economic Analysis to measure the total impact of construction expenditures on specific SMSAs within Illinois, we judge the appropriate multiplier applicable to total rehabilitation expenditure to be 3.477. The $323.4 million spend on rehabilitation projects results in an estimated total change in gross output of at least $1,100 million.

Increased Earnings

Using the multiplier compiled by the Bureau of Economic Analysis to measure the ratio of earnings and gross output, we estimate that the $323.4 million spent on certified rehabilitation projects has resulted in a $324.97 million increase in earnings within Illinois. These increased earnings, in turn, spur additional spending and create additional tax receipts for the Illinois treasury.

Employment Effects

Based upon standard construction industry ratios between construction expenditures and jobs created, we estimate that at least 15,103 jobs have been created as a result of the expenditure on certified rehabilitation projects in the state. Because rehabilitation work is more labor intensive, however, than the average construction industry job, we believe it appropriate to increase the direct construction multiplier by 33%, or 3.1 jobs per $1.0 million in rehabilitation expenditure. This means there have been 16,106 jobs created in Illinois since 1978 as a result of certified rehabilitation of historic buildings. By contrast, it has taken only two full-time jobs in the Department of Conservation to administer the program.

State of Illinois Taxes

Certified rehabilitation of historic buildings in Illinois has had a substantial positive effect on State of Illinois taxes. Total state level taxes generated by $323.4 million in certified rehabilitation expenditures in Illinois are estimated as follows:

Personal Income Taxes	$ 8,680,000
Corporate Income Taxes	318,500
Unemployment Taxes	6,060,000
Sales Taxes	14,280,000
Total	$29,338,500

County and Local Taxes

County and local governments have also benefited from the additional sales taxes and property taxes generated by certified rehabilitation of historic structures in Illinois. We estimate the total local sales taxes generated as follows:

Chicago	$7,431,600
Cook County Outside Chicago	24,400
Other RTA Counties	97,250
Other Counties	287,600
Total	$7,840,850

Completed rehabilitation projects generate significant local property taxes every year. We estimate those local property tax revenues generated annually as follows:

Adams County	$ 141,254
Alexander County	829
Carroll County	3,239
Champaign County	2,186
Cook County	23,132,703
DuPage County	7,078
Hancock County	2,486
Jo Daviess	305,876
Kane County	233,321
Lake County	7,869
Livingston County	3,528
Logan County	1,370
Madison County	1,491
Morgan County	2,558
McLean County	4,675
Ogle County	1,151
Peoria County	163,267
St. Clair County	6,072
Sangamon County	190,106
Tazewell County	80,865
Will County	3,327
Winnebago County	127,389
Total	$24,422,640

Total State and Local Benefits

The benefits we have found may be summarized as follows:

Total Certified Rehabilitation Projects	141
Total Rehabilitation Expenditures	$ 323.42 million
Total Change in Illinois Gross Output	$1,124.46 million
Total Change in Illinois Earnings	$ 324.97 million
Total Number of Jobs Created	16,106
State Tax Revenue Generated	
Personal Income Taxes	$ 8.68 million
Corporate Income Taxes	$ 0.32 million
Unemployment Taxes	$ 6.06 million
State Sales Taxes	$ 14.28 million
Total State Taxes	$ 29.34 million
Local Taxes	
Total Sales Taxes	$ 7.84 million
Total Property Taxes	$ 24.42 million
Total Local Taxes	$ 32.26 million

RESULTS OF THE DEVELOPERS SURVEY

Shlaes & Co. sent questionnaires to the 103 developers in the State of Illinois who have started certified rehabilitation projects after the advent of a 25% investment tax credit in 1981. The survey questions and responses of the developers were as follows:

How would you rate the importance of the 25% investment tax credit in making your project feasible?

Response	Number of Responses	% of Total Who Responded
Very important	40	77
Important	8	15
Slightly important	3	6
Not important	1	2
	52	100

FEDERAL INCOME TAXES AND CERTIFIED REHABILITATION IN ILLINOIS

Certified rehabilitation projects return virtually all of the investment tax credit to the federal Treasury in the form of taxes paid later because of sale of the projects and because of taxes on gross earnings generated by the rehabilitation.

When a typical eight year holding period is considered, every one million dollars in investment tax credits eventually result in a repayment to the federal government of $153,333 (15.3%) in taxes. At a discount rate of 13.0%, the present value of that eventual payment is $57,665.

That amount of tax credits or earnings generate $780,000 in individual federal income tax payments.

Every four million dollars in rehabilitation expenditure -- or one million dollars in investment tax credit -- therefore produce $17,088 in additional corporate income taxes paid by the construction industry to the federal government.

Total earnings in Illinois generated by rehabilitation affect corporations in sectors other than the construction industry. Every four million dollars in rehab expenditures -- or one million dollars in tax credits -- produce an additional $18,403 for corporations in sectors other than the construction industry.

Therefore the investment tax credit is virtually offset by total federal income taxes generated by its use, summarized as follows:

Tax at sale of property	$153,333
Personal income taxes	780,000
Corporate income taxes	35,491
Total	$968,824

Even when the income taxes returned to the federal government at sale of the property are discounted to present value, the total tax loss to the federal Treasury is only about $127,000, or 12.7% of the tax credit.

Chairman RANGEL. Mr. Hood.

STATEMENT OF JOHN A. HOOD, VICE PRESIDENT, VOLUNTEERS OF AMERICA, ON BEHALF OF THE NATIONAL ASSISTED HOUSING MANAGEMENT ASSOCIATION

Mr. HOOD. Mr. Chairman, my name is John Hood. I am testifying today on behalf of the National Assisted Housing Management Association. NAHMA represents the professional managers of privately owned, federally assisted housing.

I, myself, oversee management of over 10,000 low- and moderate-income housing units through Volunteers of America, with its headquarters in Louisiana.

NAHMA believes that the proposal listed in the subcommittee's June 2 press release for a low-income housing preservation deduction is a very creative and effective way to address the problem of the Nation's aging stock of existing low-income housing. The proposal would allow future purchasers of eligible low-income projects to depreciate the project under a straight-line, 15-year schedule, and to deduct losses from the project against nonpassive income, as in the case of the low-income housing tax credits. NAHMA hopes that the committee will seriously consider this proposal along with one I will mention shortly.

Mr. Chairman, it is widely recognized that there is a critical national shortage of affordable housing assistance. At the same time as the need is growing, the stock of already existing low-income housing has been getting older.

All the projects built under the HUD 221(d)(3) and 236 programs are over 25 years old, and many are older. The Section 8 program, which replaced these earlier programs, dates to 1974, and many of these projects are beginning to age as well.

Members of NAHMA work as property managers every day with HUD and the owners to ensure affordable, safe, sanitary and decent housing to every project assisted by these programs. Yet we face increasingly severe problems managing these aging projects.

They need capital to improve such things as roofs, heating systems, windows, and floors. In many cases the existing owners do not have the resources needed to preserve these projects and the current owners of these projects are prevented from selling to owners with additional capital by the existing tax they would have to pay on their paper gain.

Without a program to address the capital needs of this inventory, much of it is at risk. Yet to date the existing programs have not helped.

The appropriations bill the House passed a few weeks ago cut the administration's request for the flexible subsidy programs almost in half, to $35.75 million. Congress passed ELIHPA and LIHPRHA to prevent prepayment of mortgages on many of these projects. But they only apply to projects with a certain equity value that have a realistic option of converting market rate projects.

Finally, the low-income housing tax credit as currently designed has not made a significant contribution to preserving existing low-income projects. The limited size of the credit program in each State and the predisposition to encourage the construction of new

low-income housing has left little room thus far for using the tax credits to preserve low-income units.

NAHMA is already on record in support of changes designed to enhance the preservation role of the credit. The proposed changes to the tax law would make it more attractive for existing owners to take in new partners who have raised additional private capital through the use of the low-income tax credit.

The proposal will allocate to the additional investors all of the tax benefits of the credit. It will protect the existing owners from having to pay taxes on the paper gain attributed to them when their ownership interest is diluted by the addition of new partners.

We continue to strongly support this idea and want to work with you in securing its adoption. Additional measures are necessary, however, to address all those cases where new investors are unable or unwilling to obtain tax credits and to enter into joint ownership with the existing investors.

In these circumstances, the proposed housing preservation deduction, which is the subject of these hearings, provides an innovative way to provide a new incentive to investors to invest in and improve the existing low-income housing stock. This deduction would provide just enough boost to the currently depressed values of these projects to permit current investors to sell these projects without suffering an out-of-pocket loss. HUD would exercise its regulatory powers over the sale of all these projects to ensure that the ownership will benefit the project and the tenants.

The targeting requirements governing the age and type of projects eligible for the deduction would ensure that the program benefits, only the aging stock of existing low-income projects. At the same time, the expense of the new deduction to the Treasury would be offset by the capital gains tax paid by the seller.

The Joint Tax Committee estimates that the proposal would only cost Treasury over 5 years between $56 and $157 million in total, depending on the exact terms of the provision.

Mr. Chairman, we therefore hope the committee will move promptly to consider and approve both the housing preservation deduction and the changes described to permit existing owners to take in new investors.

Thank you.

[The prepared statement follows:]

Statement of Mr. John A. Hood

on Behalf of the

National Assisted Housing Management Association

Subcommittee on Select Revenue Measures

Committee on Ways and Means

July 13, 1993

Mr. Chairman my name is John A. Hood. I am testifying today on behalf of the National Assisted Housing Management Association. NAHMA represents the professional managers of privately owned, federally assisted housing. I myself am Vice President of a non-profit organization, Volunteers of America, and President of its affiliate, the VOA National Housing Corporation. In the latter capacity I oversee management of over 60 low and moderate income housing complexes, with a total of over 10,000 units. We appreciate the opportunity to testify on proposals that would promote the preservation of existing low-income housing. The condition of much of the nation's existing stock of assisted housing is a serious problem, and we compliment this subcommittee on its decision to consider this important issue as part of these hearings.

The Pressing Need to Preserve Existing Low-Income Housing.

Let me first briefly summarize the problem. Today it is widely recognized that there is a critical national shortage of affordable housing. For example, according to the National Housing Task Force, between the middle 1970s and the middle 1980s there was a decrease of 2.5 million units in the available number of affordable units renting for less than $250 a month. A 1992 Harvard study estimated that there were 4.1 million units of HUD or privately owned, publicly assisted units, while there are 13.8 million households eligible to receive HUD-funded housing assistance.

At the same time that the need for additional assisted housing grows, the stock of already existing low-income housing has been getting older.

According to figures provided by HUD, for example, there are some 561,428 remaining projects assisted under either the old Section 221(d)(3) Below Market Interest Rate program or the Section 236 program. These two programs date from the 1960s. The Section 221(d)(3) program was suspended in 1968, and the Section 236 program was suspended in 1976. Thus, all the projects built under these programs are now over 15 years old, and many are over 30 years old.

There are also a number of existing low-income housing projects originally built with HUD assistance under the old Section 221(d)(3) Market rate program. This program, which originated in the 1950s, was suspended in 1968. As a result, most of these projects are at least 25 years old, and many are older. Finally, since 1974 the major HUD program for promoting new construction for low-income tenants has been the Section 8 program, often financed under the Section 221(d)(4) insurance program. By now, many of these projects are beginning to age as well.

Altogether, according to HUD figures there are some 8,562 projects built under the Section 221(d)(3), Section 236, and Section 221(d)(4) programs that are at least 10 years and which are still serving at least a majority of low-income tenants. In

total, these projects contain some 854,980 units. Located in every state of the country, these low-income projects represent a valuable national resource. They provide decent housing to tenants who otherwise could not afford decent housing.

Members of NAHMA work as property managers every day with HUD and the owners to ensure affordable, safe and sanitary housing to every tenant in these projects. Yet we face increasingly severe problems managing these aging projects. The current owners of many of these projects purchased the projects in the early 1980s. Increasingly these projects now need capital improvements such as new roofs, heating systems, windows, and flooring.

Our assessment was confirmed earlier this year by the Administration in its February report A Vision of Change for America. In this explanation of its economic recovery plan, the Administration called generally for additional funding to "repair and restore the nation's stock of assisted rental housing, most of which is 20 to 30 years old. Many units are in deteriorated buildings. Many operators of buildings are also financially troubled."

While the need is great, in many cases the existing owners do not have the resources, or in some cases perhaps even the incentive, to preserve these projects. The market value of many of the properties has fallen significantly, fueled by the far-reaching changes made in 1986 in the tax laws and by the projects' increasing age. Either now, or in a few years, many of the projects will be fully depreciated. Additional debt financing to fund improvements is difficult to obtain, and in any event would likely lead to increased rents, and the need for additional federal funding for rental assistance.

In the past, low-income projects in need of additional capital could and frequently would be sold to new investors, who would raise additional capital to purchase and rehabilitate the projects. It is no longer possible as a practical matter to do so under current market conditions. This is because the current investors in the property would owe considerable taxes upon sale. The depreciated tax base for the projects would subject the owners to a significant "paper gain." This gain will substantially exceed the cash the owners can get for the projects. As a result, a sale would likely result in out-of-pocket losses to the investors. Few, if any, investors are interested in selling under these circumstances.

Yet, without the necessary tools to address the capital needs of this inventory, much of it will be at risk. Living conditions for the tenants may gradually deteriorate, while HUD has neither the personnel nor the resources to effectively monitor the asset. If the federal government does not act to preserve this existing housing, Congress will be faced with the far higher expense of building new low-income housing to replace the stock that has been lost.

The Absence of Any Federal Response to the Problem To Date.

Although the problem is clear, there are relatively few federal programs to address the problem. Those that exist have been largely underfunded, or have proven to date to have little applicability to the problem.

For example, HUD's flexible subsidy program was originally designed to help owners of aging low-income projects to maintain their projects. The program has been very seriously underfunded in past years, however. For FY '94 the Administration requested

$65.7 million, but the appropriation bill approved by the House on July 1 provides only $35.75 million.

Another tool for helping to preserve existing low-income housing is HUD's Section 8 Loan Management Set Aside program. But this program too has been slashed. The House-passed version of the HUD appropriation bill for FY'94 reduced this program from approximately 6,000 units to slightly more than 4,000 units.

Neither the Emergency Low-Income Housing Preservation Act of 1987 (ELIHPA), nor the Low-Income Housing Preservation and Resident Homeownership Act of 1990 (LIHPRHA) offers an answer to the needs of most of the projects. These laws were passed in response to Congressional concerns that some owners would prepay their HUD mortgages on Section 221(d)(3) and Section 236 projects at least 20 years old, and offer them to the general public at market rates out of reach of low-income tenants. ELIHPA and LIHPRHA only are available to those projects that have a realistic chance to prepay their mortgages after 20 years, and to convert to market rate projects. Many of the projects in the existing stock either may not prepay until 40 years, or they simply are not commercially viable projects for whom conversion is a realistic option. In any event, the equity value of many of the projects is so low that they could not qualify for incentives and assistance under the terms of ELIHPA or LIHPRHA.

Finally, as a practical matter the low-income housing tax credit as currently designed has not made a significant contribution to preserving existing low-income projects. As this Committee is aware, the credit has been practically the only program available to help increase the supply of low-income housing. Virtually all of the low-income housing built in the last few years has been built with credits. The limited size of the credit program in each state, and a predisposition to encourage the construction of new low-income housing has left little room thus far for using the credit to preserve existing low-income units.

In the absence of an existing programmatic solution to the problem, a number of proposals have been made for new ways to address the problem. This includes proposals to forgive the existing owners the taxes otherwise due if the current owners sell to a certain category of new buyers. Another approach would be to radically expand the funds available to HUD to directly assist these aging properties. Experience indicates that neither of these approaches is a practical solution given current budgetary restraints.

Practical Solutions to the Problem Do Exist.

The need to preserve the existing low-income housing stock is too serious a problem to defer any longer. We therefore urge this Committee to consider new approaches that use the tax code in innovative ways to provide, with little or no adverse consequences to the Treasury, new incentives to investors to invest in, and improve, the existing low-income units.

NAHMA previously testified before the Ways and Means Committee on March 23 in support of a proposal that would permit existing owners to take in new partners with additional private capital raised through use of the low-income housing tax credit. The proposal would allocate to the additional investors all of the tax benefits of the credits. It also would protect the existing owners from having to pay taxes on the "paper gains" attributed to them when their ownership interest is diluted by the addition of the new partners. We continue to strongly support this idea, and want to work with you in securing its adoption.

This approach is useful when the existing owners wish to retain a reduced interest in the project, and when the existing project is allocated some of the state's tax credits. It would not, however, address all those cases where credits are not available to the project, or when the existing owners want to sell their entire interest to new investors with new capital, rather than attempt to share ownership with the new investors.

NAHMA therefore hopes this Committee will also seriously consider the proposal listed in your June 2 press release for a housing preservation deduction to assist in the rehabilitation of certain privately-owned low-income housing.

The proposed housing preservation deduction would allow future purchasers of eligible low-income projects to depreciate the project over 15 years (straight line), and the individual investor will be able to deduct losses from the project against non-passive income, as in the case of the low-income housing tax credit. To be eligible, the project will have to be at least 10 years old, and insured or assisted under either (i) the Section 221(d)(3) Below Market Interest Rate program, (ii) the Section 221(d)(3) Market Rate program, (iii) Section 236, or (iv) Section 221(d)(4). In all these cases, at least 50% of the projects' units must be occupied by tenants with incomes that are less than 80% of the area median gross income. In the case of the Section 221d)(4) and Section 221(d)(3) Market Rate programs, at least 50% of the units must also be receiving Section 8 rental assistance. These requirements will ensure that the projects are truly serving the needy. Failure to continue to satisfy these income standards would result in the loss of the deduction. The purchaser will also have to agree to expend at least 10% of the purchase price of the building on rehabilitation work (or more if required by HUD at the time of the purchase).

The housing preservation deduction will not be available to the current owners of the project, and the investors in the entity currently owning the project will be required to pay capital gains taxes upon sale of the project. No project may participate in the program if it is also receiving benefits under the low-income housing tax credit, the Low-Income Housing Preservation and Resident Homeownership Act of 1990, or the Emergency Low-Income Housing Preservation Act of 1987. Properties that are a part of a like-kind exchange, or sold to related parties will not be eligible for the deduction. The provision would be permanent, so that it would continue to apply to any subsequent resale and purchase of the property. The benefits provided the new owner in the form of deductions would be recaptured by the Treasury when the property is subsequently resold.

The deduction would make it possible to replace the current owners of the projects with new owners who would have the private capital and the motivation to maintain the property for the tenants. And at the same time, HUD could exercise its regulatory powers to ensure that sales only took place when it was to the benefit of the project and its tenants.

The housing preservation deduction could encourage the sale and rehabilitation of projects with little or no cost to the Treasury. This is because the expense of the tax benefits available to the new owners would be offset by the capital gains taxes paid by the seller, and because the tax benefits provided the new owners would be recaptured when the property is resold.

I understand that the Joint Tax committee has in fact estimated that the proposal would only cost the Treasury a total over 5 years of between $56 million and $157 million, depending on the exact terms of the provision.

This approach, and the one I previously mentioned that would modify the low-income tax credit, are complementary. They both can make substantial contributions to preserving the existing low-income housing stock.

* * * *

In short Mr. Chairman, there is a serious need to preserve the aging stock of privately-owned assisted housing stock. This will never happen without some assistance from the federal government, since otherwise there is little incentive for private investors to invest in assisted housing. The low-income housing tax credit is one such effort. It has been effective in encouraging through the tax code private investment in new low-income housing, but it has not yet been of any great help to existing housing. Our proposal previously outlined by NAHMA President Charles Wilkins in another hearing before the Ways and Means committee will address this matter. Other relief from the tax laws especially designed to aid existing housing is also needed, however. The low-income housing preservation deduction that is the subject of this hearing offers one very creative and effective way to address this problem. We hope the Committee will move promptly to explore and approve both proposals.

Chairman RANGEL. President Lewis, good to see you again. Welcome to the committee.

STATEMENT OF TERRY LEWIS, PRESIDENT, NATIONAL ASSOCIATION OF HOUSING COOPERATIVES

Ms. LEWIS. Thank you, Mr. Rangel.

It is a pleasure to be here and it is a pleasure to speak on behalf of a bill that you know well, H.R. 1908, which you have introduced to clarify section 277 of the Internal Revenue Code does not apply to housing co-ops.

I have substantial written information in my statement. I would like also to submit the written statement of Russell Nota, the president and chief executive officer of the National Cooperative Business Association——

Chairman RANGEL. Without objection.

Ms. LEWIS [continuing]. In support of our statement.

What I would like to do today is essentially summarize my written statement and expand on the excellent remarks of Mr. Schumer.

You know, housing cooperatives are the oldest form of multifamily resident ownership in this country. Long before there was ever a condominium, people got together to form a corporation to own multifamily housing and then to lease it back to themselves as shareholders in that corporation. That is what a housing cooperative is, and I know you know that very well.

Half of the housing cooperatives in this country are in the New York City area, but the other half are scattered around the country in every urban and many rural locations.

You had the opportunity about a week and a half ago to speak before a board meeting of the National Association of Housing Cooperatives. I asked the people who were not from the New York City area to stand up and most of the people in the room did so.

Housing cooperatives are recognized by the Federal Government as an excellent purveyor of affordable housing. Housing cooperatives have been assisted through FHA mortgages.

Housing cooperatives have been formed under the 221(d)(3) and 236 program, and housing cooperatives exist outside of any Federal, State or local assistance, insurance or subsidy program. They do a better job of providing affordable housing than any other form of ownership.

In 1971 a study by the Federal Government indicated clearly that housing cooperatives defaulted less under the 221(d)(3) program than either for-profit rental housing or nonprofit-owned housing.

In the 213 program, rental housing has substantial defaults. The co-ops under the 213 program get a rebate on their insurance premium every year.

Recently a study was done comparing rental housing managed by the same managing agent as cooperatively owned housing. In every case there was a significant cost savings in the cooperatively owned housing.

Why is that? There is nothing more important than cost savings to the residents of cooperative housing. They own that building. They don't pay a profit to anybody.

Now, cooperative housing, along with other forms of cooperative ownership, has been taxed comprehensively under subchapter T of the code, since before the 1954 Tax Code.

Your bill simply codifies what NAHC has argued for many years is existing law. It includes the protections that case law have added to the statutes against any form of tax shelter by codifying *Farm Service Cooperative* v. *Commissioner.*

This is a provision that is regarded as important by the Office of General Counsel at Treasury. On that basis, it also goes ahead to specify the treatment that we believe existing law would accord under subchapter T in certain repeated situations that have been the object of IRS scrutiny under 277.

Our position has been vindicated between the time this statutory language was drafted and now by a decision called *Landmark, Inc.* v. *the United States,* in which the Court of Claims held that 277 did not apply to housing cooperatives. There was not a housing cooperative involved—and has mentioned the Farm Service Cooperative as a substantial reason why 277 ought not to be imposed after the fact on cooperatives under these circumstances. Given that your bill simply codifies what we believe to be existing law, the retroactive provisions in your bill are very important.

Trump Village Three, which Mr. Schumer spoke so compellingly about, is low- and moderate-income, and state Mitchell-Lama. Of those elderly persons, it is estimated that currently about 10 percent are on some form of assistance.

If the IRS succeeds in imposing that 3 million dollars' worth of penalties, the increase in carrying charges that will have to be charged to those people will mean that at least three times as many, and perhaps as many as six times as many, of those elderly residents will have to go on assistance in order to be able to remain in their units. That is not a result that I believe you would approve of and I don't believe that is a result that the Congress would approve of.

Thank you very much.

[The prepared statement follows:]

Statement of Terry Lewis
President
National Association of Housing Cooperatives
Before the
Subcommittee on Select Revenue Measures
Committee on Ways and Means
U. S. House of Representatives

July 13, 1993

Mr. Chairman and Members of the Subcommittee:

Today, I am pleased to testify before you in support of H.R. 1908, a bill introduced by Chairman Rangel to clarify that Section 277 of the Internal Revenue Code does not apply to housing cooperatives. H.R. 1908 will also clarify how certain income of a housing cooperative is to be taxed under subchapter T of the Code. These provisions will promote tax fairness and erase a serious threat to the viability of much of our country's stock of affordable, cooperatively-owned housing.

In cities large and small across this nation, cooperatives provide affordable housing to their resident-owners through efficient, cost-based operation. The federal government has fostered this affordable housing through FHA-insured mortgages and through assistance under a wide variety of housing programs designed to aid low- and moderate-income families. State and local governments have added their own support through a variety of funding strategies.

Some of these cooperatives go beyond providing affordable housing to their current resident-owners by controlling resale prices and thus retaining affordability to a target population of low- and moderate-income potential purchasers.

All of these cooperatives are threatened by a recent practice of the IRS which seeks to break apart the cooperative enterprise, and separately tax sources of income which, though functionally tied to the provision of housing, would, when set apart, have few or no offsetting deductions.

Here is just one example: when cooperatives accumulate reserves to replace worn-out roofs, furnaces and water-heaters (as they are required to do when they are financed by FHA-insured mortgages) and prudently invest those reserves in federally-insured CD's or savings accounts (as they are also required to do under FHA regulation), that interest income would be set apart and subject -- without deductions -- to taxation at the highest corporate rate.

This punitive result is based on an IRS position with dubious legislative foundation -- an attempt to apply section 277 of the Code, adopted in 1969 to deal with non-exempt country clubs and the like -- to cooperative housing corporations.

By its own terms, §277 applies to "a social club or other membership organization". As the U.S. Court of Claims held in Landmark, Inc. v. U.S., it does not apply to "corporations doing business on a cooperative basis" (including, per Park Place v. Commissioner, 57 T.C. 767 (1972), "cooperative housing corporations" as defined in IRC §216), which are the subject of comprehensive tax treatment under subchapter T of the Code.

The legislative history of §277's 1969 enactment strongly denies its applicability to cooperatives. While the House Report referred to "cooperatives" as potentially falling under §277, the Senate and Conference Reports dropped all reference to cooperatives. The Senate Finance Committee decided that the tax treatment of cooperatives was to be extensively studied and that a legislative proposal should be developed after the study. The revenue estimates accompanying the Senate Finance Committee Report on §277 show no revenue impacts on cooperatives.

The Senate floor debate is conclusive. Senator Ribicoff proposed an amendment to tax the income of cooperatives from activities unrelated to their basic marketing and purchasing functions. As reported in 115 Cong. Rec. (December 4, 1969), he stated:

> Regrettably, the Senate bill has deleted even those weak amendments dealing with

cooperative taxes contained in the bill passed by the House of Representatives.

> *The Finance Committee has also imposed a tax on the unrelated activities of social clubs, fraternal organizations, and even churches. Where these organizations have extended their activities into fields outside the scope of tax exemption, the income from these activities will be taxed at regular corporate rates.*
>
> *It is hard to justify a bill which taxes the unrelated functions of these groups yet has ignored the same type of activities of cooperatives.* (at 37063, emphasis added)

After debate, including a statement by Senator Talmadge pointing out that, under subchapter T, nonexempt cooperatives were already subject to tax on their nonpatronage earnings (at 37061 - 37062), the Senate voted 81-11 against Senator Ribicoff's amendment.

It doesn't seem likely that the Senate voted and debated without purpose.

In support of its position, the IRS ignores this legislative history and points to the 1976 legislative history of §528 (relating to the taxation of condominium associations), which contains a gratuitous remark suggesting that §277 applies to housing cooperatives.

It is black letter law that statements of a subsequent Congress are without authority as to the legislative intent of an earlier Congress (See, e.g., Rolling Rock Country Club v. U.S., 785 F.2d 93 (3d Cir., 1986)). Even were that not the case, the Conference Report for the 1989 Budget Reconciliation Act demolishes any inference raised by the 1976 legislative history of §528. The House version contained a provision (not found in either the Senate version or the final bill) amending the tax treatment of cooperative housing corporations upon dissolution. The Ways and Means Committee Report had included, by way of explanation, a reference to a Tax Court case (Concord Consumer Housing Cooperative v. Commissioner, 89 T.C. 105 (1987)) applying §277 to a housing entity which it expressly declined to consider either a "cooperative housing corporation" under IRC §216 or a "corporation doing business on a cooperative basis" under subchapter T. The Conference Report states the following, with regard to the reference to Concord Consumers:

> In this case, both parties assumed that section 277 applied and no issue regarding its application was raised. The Tax Court did not determine whether the taxpayer was a section 216 housing cooperative. The Tax Court thus did not specifically reach the issue whether section 277 applies to a section 216 housing cooperative. The conferees wish to make clear that no inference one way or the other is intended by reference to this particular case. (emphasis added)

While H.R. 1908 will clearly solve the problem, it is the litigating position taken by the IRS, not existing law, which makes it necessary. Housing cooperatives are doing their best to battle the IRS in the Courts, where resolution may take ten to fifteen years. In the meantime, the IRS has proposed deficiencies and added penalties which are forcing numerous individual cooperatives to choose between substantial and unfair over-payments or expensive litigation. Either choice is costly, and thus a threat to the precious stock of affordable housing which this Congress has fought so hard to defend.

H.R. 1908 eliminates the threat, both prospectively and retroactively, by making it clear that a cooperative housing corporation is not subject to section 277, by codifying the applicability of subchapter T of the Code, which comprehensively deals with the taxation of cooperative entities, to housing cooperatives (the holding in Park Place, supra.) and by going on to eliminate the need for further costly litigation by specifying appropriate tax treatment in certain frequently-encountered situations. To the greatest extent possible, the bill attempts to codify what the National Association of Housing Cooperatives believes and has argued for many years is existing law. To a large extent (the case did not present an opportunity to test all of our arguments), our position has been vindicated by the U. S. Court of Claims in Landmark, Inc. v. U.S., supra.. Viewed in this light, the Bill's retroactivity is amply justified.

Chairman Rangel's bill reaches for fairness and the elimination of uncertainty by codifying what can objectively be considered to be existing law. While it eliminates the threat of over-taxation, you can rest assured that it will not create any loop-holes or inappropriate tax advantages. It contains a specific restriction against the set-off of losses related to the provision of housing against unrelated income. This provision effectively codifies Farm Service Cooperative v. Commissioner, 619 F.2d 718, 725 (8th Cir. 1980), rev'g. in part 70 T.C. 145 (1978), which is viewed as an important clarification by the IRS.

In prospective form, this bill has twice been included by Congress in revenue measures which, for unrelated reasons, were vetoed by former President Bush.

I know that each of you is concerned with tax fairness and that many of you have shown special concern for protecting affordable housing. This bill strives for both, and deserves your utmost support.

Chairman RANGEL. Thank you.

I agree with you. If we are clarifying the law and we find that there has been an inequity in the terms of existing law, retroactive certainly should be the equitable thing to do. We are having a problem, of course, with Treasury, and perhaps the other body, as they resist any legislation being retroactive.

I can see where the liability is retroactive, that there should be an inequity objection, but certainly not in removing the liability that should not have existed in the first place.

So I want to thank you for the leadership that you and your national association have provided in this area, because it helps when it doesn't appear to be a New York problem.

As relates to the tax credits for preservation, I personally have offered and supported tax credits in the code to do what it appeared as though our country was not prepared to do. But I really don't think that it is equitable to use the Tax Code to provide a social good when basically we are providing shelters and opportunities for the very wealthy to get a benefit. And whether it is targeted jobs credit or it is low-income housing credit, or whether it is preserving our national heritage, these things which a nation should do because it is the right thing to do, we find ourselves rewarding people as investors rather than as patriots.

How would you respond to that, Mr. Schwartz?

Mr. SCHWARTZ. Mr. Chairman, what we find is that the credit tends to be used in the inner cities to help revive neighborhoods that are distressed, that the credit tends to be used to provide housing for low-income people——

Chairman RANGEL. Mr. Schwartz, the credit tends to do that because the law targets it to these areas. But it is not that the investor cares where it is being used; is it? I mean, we don't find people who want to help the poor, so therefore they are going to invest.

I have never thought that that was being used in order to get people to take advantage of the bill.

Mr. SCHWARTZ. I would say, Mr. Chairman, this is a direct analog to the low-income housing credit. In many cases the investors who provide the equity capital to build those low-income units, they don't particularly have a social objective in mind. They are trying to realize a return on their equity and yet they are achieving a social purpose, which is providing housing for low-income people.

Chairman RANGEL. Mr. Schwartz, if the objective was not as you stated it, I would not be supporting these credits. I am just asking whether or not, in your opinion, we should continue the credit route and just give up on our Government and in not doing what is right and equitable, and that is to protect our heritage.

I just sometimes get annoyed that it takes rich investors in order for our government to do the right thing.

Mr. SCHWARTZ. Well, it is a frustration to us, too, Mr. Chairman.

Chairman RANGEL. You would prefer that it would be done in the grants and other ways rather than through incentives to people to not pay their just taxes?

Mr. SCHWARTZ. I think our experience has been that it takes a measure of financial incentive to make these preservation projects happen, and unfortunately that is the case.

Chairman RANGEL. I am embarrassed because I came here to reform the tax law and it looks like I am providing more credits and loopholes than most of the Members on the committee, but we will keep doing it until we get it right.

Yes, ma'am, Ms. Longsworth.

Ms. LONGSWORTH. One of the things that should be noted is that the rehab credits are a very low administrative overhead program. For instance, in the State of Illinois, when I talked about 323 million dollars' worth of investment, the certification was done by two full-time employees in the State of Illinois. So we offer something where the private investor really has an opportunity to help our cities and doesn't have to go through layers and layers of bureaucracy. It has been very effective because of that.

Historic rehab has to meet the Secretary of Interior's standards, standards for qualification of the building and for rehab. We feel that is important because it limits the universe of properties that are eligible. Many of those properties are abandoned schools in neighborhoods that could meet the needs of the elderly or families rather than being fenced up.

When I heard witnesses talk about industrial factories being fenced up because of toxic waste, I decided it is just as bad to have a major building abandoned in the center of a neighborhood as it is to have an industrial site, and we feel that the rehab credits have been successful in reversing this national problem.

Chairman RANGEL. But you are not suggesting that the government could not direct that funds be directed in the same way. I mean, it is not the generosity of the investor that allows the area to be rehabilitated, or targeted. I mean, any bureaucrat could say, save that and rehabilitate this, and this is what our government is prepared to share with you in doing it.

I mean, if we have a system here where—we have just gone through a tax reform and we are just about to undo all of those things that we have done because government won't do it, so we give incentives to people to do what government won't do.

I am a part of the conspiracy, so I am not being critical. I just hope that there would be more people that would be prepared to pay a little more in taxes so government can do the right thing rather than have a handful of people, relatively speaking, in terms of taxpayers, pay less than their share of taxes in order to do the right thing by communities and national heritage, and building low-income housing and providing jobs.

It just seems to me that is not the way it should be, because if we do that, we could just have the rich pay no taxes and just invest. And we know that capital formation is essential if we are going to have an economy that is lubricated enough so that even the poor will be in a position to pay some taxes rather than be unemployed.

So I just hope that we don't give up on the Government in every area so that we have to rely on tax shelters. That complicates the system to such an extent that you find middle-income people that can't afford to take the risk, as low as it might be, for investment, paying higher taxes than those people that know how to best invest and avoid liability. I still haven't given up on tax reform.

Thank you so much for the contribution that you have made. We will continue to support these projects until we can find a way to do it better.

OK, panel 4, Public Securities Association, R. Fenn Putman, vice chairman, also executive vice president and managing director of the Municipal Finance Department, Lehman Bros., New York; National Council of Health Facilities Finance Authorities, Roy A. Pentilla, who is also executive director, Michigan State Hospital, Financing Authority, Lansing, Mich.; South Carolina Research Authority, Columbia, S.C., Dr. Robert Henderson, director; and the National League of Cities, Aurel M. Arndt, general manager, Lehigh Pennsylvania Authority, Allentown, Pa.

Your entire statements will be entered into the record by unanimous consent. You may proceed with the time allotted in any manner that you want.

We will start off with the Public Securities Association, Mr. Putman.

STATEMENT OF R. FENN PUTMAN, VICE CHAIRMAN, PUBLIC SECURITIES ASSOCIATION, AND MANAGING DIRECTOR, PUBLIC FINANCE DEPARTMENT, LEHMAN BROS., INC., NEW YORK, N.Y.

Mr. PUTMAN. Thank you, Mr. Chairman, and good afternoon. My name is Fenn Putman. I am the managing director in the Public Finance Department at the investment banking firm of Lehman Bros. I speak to you this afternoon as vice chairman of the Public Securities Association, the PSA. It is the international trade organization of banks and securities firms that underwrite and trade municipal securities, U.S. Government and agency securities, mortgage-backed securities and money market instruments, totaling over some $7 trillion. PSA membership accounts for about 95 percent of the Nation's municipal market activity.

PSA commends you, Mr. Chairman, for your leadership on many issues which PSA strongly advocates, particularly empowerment zones, the low-income housing tax credits and mortgage revenue bonds.

We also commend you and this subcommittee for holding this hearing and I am grateful for this opportunity to participate.

The public finance department of Lehman Bros. is responsible for structuring and bringing to market the bond offerings of State and local governments and governmental authorities around the Nation. Virtually every day we work with States and localities to finance the construction of everything from hospitals and bridges to airports, sewer systems, highways, educational facilities, and low-income housing projects.

Since investors in tax-exempt securities issued to pay for these programs are willing to accept yields below those on taxable securities, State and local governments are able to borrow money at the lowest possible cost through the municipal bond market. Therefore, the tax-exempt feature of most municipal securities is a critically important form of Federal assistance and encouragement for State and local governments to invest in capital projects.

In April, PSA submitted written testimony to this subcommittee on the tax-exempt bond provisions contained in the President's tax

and budget package. Our written statement discusses a broader range of these issues before the subcommittee today and contains much greater detail than time allows me to cover here. Largely as a result of the provisions contained in the Tax Reform Act of 1986, the tax-exempt bond market over the past 6 years has become excessively dependent on the individual investors as a source of demand.

A significant result of the act has been the dramatic loss of commercial bank demand for most municipals. Banks now participate primarily in the market for bonds issued by very small communities that sell $10 million or less per year.

Communities that qualify as issuers of so-called bank-qualified bonds enjoy the ability to issue securities with yields significantly below those offered by communities that do not qualify. Raising the annual issuance limit for bank-qualified bonds from $10 to $25 million as contained in H.R. 2171, a bill proposed by Congressman John Lewis, would extend the interest rate benefits of bank deductibility to a wider group of small communities and would provide small issuers with greater latitude in planning their financial activities. We support H.R. 2171 and urge its quick enactment.

Another measure before the subcommittee would maximize the usefulness of tax-exempt bonds to nonprofit organizations. Currently, the Tax Code imposes many restrictions on the ability of these 501(c)(3)s to use tax-exempt financing.

The most significant restriction is the $150 million limitation on the amount of tax-exempt bonds that nonhospital 501(c)(3) organizations can have outstanding at any one time.

Legislation introduced recently by Congressman Matsui, H.R. 2022, would redefine bonds issued by 501(c)(3) organizations as public purpose bonds and lift the restrictions that now apply to the issuance of 501(c)(3) bonds, including the $150 million outstanding limit. The provision would allow nonprofit organizations in need of large amounts of capital, including private, research-intensive colleges and universities, to take advantage of the same financing tools available to public institutions. PSA supports Congressman Matsui's proposal.

One of the most significant limitations on tax-exempt bond issuance, known as the unified volume cap, restricts the annual volume of so-called private-activity bonds that can be issued by each State. Among the projects that must vie for financing under the cap are mortgage-revenue bonds, small-issue industrial development bonds, and a variety of infrastructure projects involving public-private partnerships.

It is public-private partnerships that have been looked to in recent years to fill the void created by reduced governmental resources. President Clinton's economic policies call for encouraging such partnerships. In recent years, inflation has eroded the value of the volume caps and prevented the vast array of projects needed by States and localities from being built.

Exempting public uses from private-activity bonds and statewide volume caps, or at least indexing the volume caps to inflation, would greatly enhance the ability of public-private partnerships to address investment needs.

The final tax-exempt proposal I wish to address today would improve the ability of States and localities to leverage Federal funds provided under the State revolving loan fund program. The most popular structure for leveraging waste-water revolving funds is where a State reserves all or a portion of the Federal Government's contribution as a reserve against State bond issues. The proceeds of the bond issue, which can be as large as three to four times the size of the reserve, are lent to communities. However, the reserve fund must be treated as bond proceeds for the purpose of investment yield under tax-exempt bond arbitrage rules. This means that States must restrict the yield that they earn on the investment of these reserves even though the funds do not result from proceeds of a bond issue.

One way to encourage States to leverage their Federal contributions to a greater extent and to expand indirectly the size of the revolving funds would be to allow unrestricted investment of reserves that back revolving fund bonds. The proposal before the subcommittee would, to an extent, accomplish this goal.

The municipal market is now a very effective and efficient marketplace, free of the abusive situations that motivated many of the changes in 1986. Now the municipal bond market stands ready to help the Federal, State and local governments finance much needed public investment.

There seems to be an agreement that our Nation's transportation and environmental infrastructure needs attention. Through proper targeting, the Tax Code can be modified to utilize fully the cost-effectiveness of the tax-exempt municipal bond market as a tool in meeting these policy goals.

Thank you, Mr. Chairman.

[The prepared statement follows:]

PSA

Statement of R. Fenn Putman
Managing Director, Lehman Brothers, Inc.
and Vice-Chairman, Public Securities Association

before the

House Committee on Ways and Means
Subcommittee on Select Revenue Measures

July 13, 1993

Thank you, Mr. Chairman, and good morning. My name is Fenn Putman. I am a managing director in the public finance department at the investment banking firm of Lehman Brothers, Inc. I speak to you this morning in my capacity as Vice-Chairman of the Public Securities Association (PSA). PSA is the international trade organization of banks and securities firms that underwrite and trade municipal securities, U.S. Government and agency securities, mortgage-backed securities and money-market instruments. PSA's membership accounts for about 95 percent of the nation's municipal market activity. PSA commends you, Mr. Chairman, for holding this hearing, and we are grateful for the opportunity to participate.

The public finance department at Lehman Brothers is responsible for structuring and bringing to market the bond offerings of state and local governments and governmental authorities around the nation. Virtually every day we work with states and localities to finance the construction of everything from hospitals and bridges to airports, sewer systems, highways and low-income housing projects. Municipal bond financing plays a vital role in making possible hundreds of billions of dollars of public investment every year, and helps pay for the water we drink, the roads on which we drive and the schools in which we educate our children. With that in mind, I would like to speak to you this morning on a few of the many proposals before this Subcommittee related to the tax-exempt municipal bond market.

I am very encouraged to see so many proposals before the Subcommittee that address the use of tax-exempt financing for a wide variety of targeted purposes. The tax-exempt feature of most municipal securities is the most important form of federal assistance and encouragement for state and local governments to invest in capital projects. When cooperation among federal, state and local governments and the private sector in financing public projects is warranted and justified, expanding the use of bonds is one of the most efficient ways to provide federal assistance. It is from this perspective that PSA approaches many of the proposals before the Subcommittee this morning.

In April, PSA submitted written testimony to this Subcommittee on the tax-exempt bond provisions contained in the President's tax and budget package, and on several other recommended proposals which would serve the President's policy goals. In this statement, we address the miscellaneous tax-exempt bond proposals before the Subcommittee today.

Bank Purchases of Municipal Bonds

Over the past six years, the tax-exempt municipal bond market has become excessively dependent on individual investors as a source of demand, largely as a result of provisions

contained in the Tax Reform Act of 1986. One significant result of that Act has been the substantial loss of commercial bank demand for most municipals. Banks now invest only in the market for bonds issued by very small communities that sell $10 million or less per year. Raising the annual limit would extend the benefits of bank demand to a broader group of small communities. Legislation introduced recently by Congressman John Lewis, H.R. 2171, would raise the limit to $25 million.[1] The same recommendation was made in the 1989 report of the Anthony Commission on Public Finance, a panel chaired by former Congressman Beryl Anthony. As Governor of Arkansas, President Clinton was a member of the Anthony Commission, and he endorsed the Commission's recommendations. A similar proposal on bank-qualified bonds was included in H.R. 11, passed last year by the 102nd Congress. In testimony before this Subcommittee recently, Assistant Treasury Secretary Samuels stated that the Clinton Administration does not oppose raising the limit to $20 million.

The Tax Reform Act of 1986 (TRA) influenced municipal finance by shifting the incentives facing potential investors in bonds. The most immediate effect of the TRA with respect to demand involved commercial banks. Prior to the TRA, commercial banks were allowed to deduct 80 percent of their interest costs associated with holding tax-exempt bonds. The bottom-line earnings attributes of municipal bonds made them an efficient tool for bank asset management. Accordingly, banks were active players in the bond market. By the end of 1985, banks held $231 billion worth of all municipal bonds outstanding, or 35 percent.

The TRA, however, eliminated the ability of banks to deduct interest costs associated with carrying tax-exempt securities for all but a small class of municipal bonds. Congress took this action to ensure that commercial banks could not eliminate their income tax liability. PSA does not quarrel with the underlying premise of this policy goal. Rather, we are concerned about the impact that loss of bank deductibility has had on the composition of demand for municipal bonds, and by extension, what these demand changes portend for the future cost of borrowing for state and local issuers.

As a result of the 1986 Act, banks have steadily reduced their holdings of bonds. By the end of 1992, banks held less than $98 billion worth of bonds, amounting to a reduction of $133 billion since 1985. This reduction was accomplished through both the selling of investments purchased prior to the 1986 Act, or the calling or maturing of those bonds. Consequently, commercial banks as a group no longer strengthen the bond market, but weaken it, since by selling bonds they add more supply to the market. In fact, banks undoubtedly would be selling at a greater rate but for the fact that their holdings in 1986 were grandfathered from the loss of bank deductibility.

Although it is difficult to quantify precisely, the loss of bank demand has certainly kept municipal yields higher than they otherwise would have been. One can get an idea of the importance of bank demand by examining the one sector of bonds that banks are allowed to purchase with deductibility. In 1986, Congress decided to support the market for bonds issued by small cities and towns by allowing banks to deduct 80 percent of the cost of carrying public purpose[2] (non-private activity) bonds issued by communities that issue $10 million or less in such bonds annually. Congressional policy goals have been served well by this provision. Although disinvesting in the municipal market as a whole, banks have remained active in the market for bonds issued by small communities (so-called "bank qualified" bonds).

Communities that qualify as issuers of bank-qualified bonds enjoy a yield advantage over similar communities that do not qualify. This advantage varies widely depending on market

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[1] Item nine of the tax-exempt bond proposals contained in the Subcommittee's Press Release #4 dated June 2, 1993 proposes raising the bank-qualified bond limit to $20 million.

[2] The Internal Revenue Code distinguishes between bonds issued for purely public uses and bonds issues for projects with a significant element of private participation. The Code defines "private-activity" bonds as issues where ten percent or more of the bond proceeds are used by a private entity and ten percent or more of the debt service is secured by a private entity. In general, private-activity bonds cannot be tax-exempt. However, tax-exempt private-activity bonds are permitted for certain specific types of projects and facilities, subject to volume caps and other restrictions.

conditions, but is currently somewhere in the neighborhood of 20 to 30 basis points (0.20 to 0.30 percentage points) and has been as high as 40 basis points in 1992. In other words, small issuers are able to finance their public needs more economically because the "bank-qualified" provision stimulates bank investment. In 1989 approximately $11.5 billion in bank-qualified securities were issued, resulting in an interest cost savings of between $173 million and $228 million for those issuers over the lives of their issues.

PSA recommends raising the annual issuance limit for bank qualified bonds from $10 million to $25 million, as contained in Congressman Lewis' bill. Raising the limit would extend the interest rate benefit of bank deductibility to a wider group of small communities and would provide current small issuers with greater latitude in planning their financing activities.

Bonds Issued by 501(c)(3) Organizations

Under current law, private entities generally cannot issue tax-exempt securities. However, an exception is provided for certain types of private-activity bonds, including bonds issued by tax-exempt, 501(c)(3) organizations. In order to curb the issuance of such securities, the Tax Code prohibits non-hospital 501(c)(3)s from having more than $150 million of bonds outstanding at one time. The Code also classifies 501(c)(3) bonds generally as private-activity bonds, and hence imposes on them certain restrictions that are not applicable to governmental municipal bonds. The limitations on 501(c)(3) bonds, and especially the $150 million outstanding provision, have been particularly restrictive for private, non-profit colleges and universities, who are heavily capital-dependent, especially with regard to research facilities. Legislation introduced recently by Congressman Robert Matsui, H.R. 2022, would redefine bonds issued by 501(c)(3) organizations as public purpose (non-private-activity) bonds and lift the restrictions that now apply to the issuance of 501(c)(3) bonds, including the $150 million outstanding limit.[3] H.R. 11, passed by Congress last year, would have had the same effect. Assistant Secretary Samuels stated recently before this Subcommittee that the Administration does not oppose this proposal.

Private-activity bonds are generally subject to certain issuance restrictions and limitations on investment. Bonds issued by 501(c)(3) organizations are subject to some of the restrictions, but exempt from others. For example, 501(c)(3) bonds are exempt from the annual unified volume cap restriction that limits the issuance of other allowable private-activity bonds. Interest earned on 501(c)(3) bonds also is not subject to the individual alternative minimum tax. However, certain restrictions do apply to 501(c)(3) bonds. For example, private-activity bonds, including 501(c)(3) bonds, cannot be advance refunded. In addition, the portion of bond proceeds that may be used to pay for the cost of issuing private-activity bonds, including 501(c)(3) bonds, is limited to two percent of the amount of the issue which, in current market conditions, is not a limitation. The most significant restriction is a $150 million limit on the amount of tax-exempt bonds that a non-hospital 501(c)(3) organization can have outstanding at one time. The volume restriction is most acute for private, not-for-profit colleges and universities.

The $150 million outstanding limit was imposed by Congress in 1986 to restrict the tax-exempt borrowing of large, well-endowed, private, non-profit colleges and universities. However, the limit is becoming increasingly restrictive for smaller educational institutions. Although it is especially problematic for institutions with an emphasis on research, where significant investment in buildings and equipment is required, it also applies to borrowing for whatever capital investment may be needed by any private, not-for-profit college or university. No similar restriction exists for public colleges and universities. Public institutions are permitted to issue whatever volume of tax-exempt debt they can support.

Because the $150 million limit is becoming increasingly restrictive for smaller educational institutions, and because the limit puts private institutions at a disadvantage to public

[3] This provision is identical to item 13 of the tax-exempt bond proposals contained in the Subcommittee's Press Release #4 dated June 2, 1993.

institutions with respect to their ability to borrow funds as cost effectively as possible, the PSA strongly supports H.R. 2022 and urges its quick enactment.

A second proposal before the Subcommittee would amend the bank deductibility rules for bonds issued by 501(c)(3) organizations.[4] Under current law, 501(c)(3) bonds are eligible for bank investment, subject to the $10 million per year issuance limit per issuer. Because many 501(c)(3) institutions that borrow in the tax-exempt market often issue bonds through a state or local agency or authority — and the authority's annual issuance exceeds $10 million — this limitation effectively prohibits bank investment in the bonds issued by many small, tax-exempt organizations, and raises the cost of financing for many worthwhile projects. Under the Subcommittee proposal, the bank deductibility limit for 501(c)(3) organizations would be lowered from $10 million to $5 million annually, but would be applied at the borrower, rather than the issuer, level.

Non-profit entities, including hospitals, schools, colleges, nursing homes and religious and civic organizations, are responsible for a wide variety of worthwhile community projects, such as low-income housing projects and educational and health-care facilities, projects worthy of federal encouragement and assistance. For this reason, and because small 501(c)(3) borrowers tend to have a more difficult time raising capital than larger entities, PSA feels it is appropriate and desirable to encourage bank investment in bonds issued by small 501(c)(3) organizations. Such a proposal is also consistent with a proposal made by the Anthony Commission to apply the bank deductibility limit at the borrower level, rather than at the issuer level, for all small bond issues. We support applying the small issuer limit at the borrower level.

State Bond Volume Caps

Private-activity tax-exempt bonds, which include mortgage-revenue bonds (MRBs) and small-issue industrial development bonds (IDBs) as well as bonds issued to finance various environmental infrastructure facilities and low-income housing projects, among other uses, are collectively subject to state private-activity bond volume caps. It is necessary for project developers to compete with each other for cap allocation in order to obtain tax-exempt financing. Moreover, since the current cap was imposed in 1986, its amount has never been indexed for inflation. Many worthwhile projects never get financed because of volume cap limitations. The problem is particularly acute in large, populous states.

The Tax Reform Act of 1986 imposed a number of limitations on the issuance of tax-exempt bonds by states and localities. One of these limitations, known as the unified volume cap, restricted the annual volume of so-called "private-activity" bonds that can be issued by each state. It is public-private partnerships that have been looked to in recent years to fill the void created by reduced governmental resources. President Clinton's economic policies call for encouraging such partnerships. Among the projects financed under the cap are mortgage-revenue bonds (MRBs), small-issue industrial development bonds (IDBs), and a variety of infrastructure projects involving public-private partnerships. In 1986, the cap was set at the greater of $75 *per capita* or $250 million per state. Beginning in 1988, the cap was lowered to the greater of $50 *per capita* or $150 million. In recent years, a number of states have begun to exhaust their annual volume caps and have been forced to postpone or cancel investment projects involving private activity because tax-exempt financing could not be secured.

Since 1988, inflation has eroded the value of states' volume caps. In real terms, the value of volume caps actually decreases each year. In constant 1988 dollars, the current cap is about $41.25 *per capita* or $120.8 million, not $50 *per capita* or $150 million. Without any conscious federal policy decision, the value of state volume caps has fallen by nearly 20 percent in just five years. Under current law, inflation will continue to erode their value, and fewer and fewer projects will be able to be financed.

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[4] See item eight of the tax-exempt bond proposals contained in the Subcommittee's Press Release #4 dated June 2, 1993.

The original decision by Congress in 1986 to reduce the cap beginning in 1988 was based on the assumption that states' authority to issue MRBs and IDBs would expire at the end of 1987. In fact, because these programs have proven cost effective and successful, they have been extended several times since then, but the volume cap has not been restored to its 1987 level.

The erosion of states' abilities to issue private-activity bonds has caused a number of states to exhaust their cap. In 1992, for example, private-activity issuance in five states totaled at least 90 percent of the states' caps. In 37 states, private-activity issuance plus allocated volume that makes up the carryforward allowancetotaled at least 90 percent of the cap.[5] Data on eight states' 1992 volume cap allocations are not yet available. However, 1992 was an unusual year because the authority to issue MRBs and IDBs expired on June 30, 1992.

Thus far in 1993, there appears to be slightly less pressure on the state volume caps. This is attributed to two identifiable reasons. First, because of the historically low interest rates, issuers' primary focus in the last six months has been to reduce the cost of existing debt and refund outstanding issues. This has actually reduced new money volume for public and private activity bonds. This downward pressure on new money volume has also been caused by increased difficulty on the part of issuers to identify sufficient revenue to support new projects. Secondly, the lapse of the MRB and small-issue IDB programs has caused issuers to delay allocations of volume cap because there is an anticipation that these programs will be reauthorized.

Earlier this year, the House, with the President's support, approved a permanent extension for MRB and small-issue IDB programs. If those programs had been in place for all of 1992, more states would have exhausted their caps. In 1991, private activity bond issuance in 13 states totaled at least 90 percent of volume cap. In 37 states, private-activity issuance plus allocated volume that makes up the carryforward allowance totaled at least 90 percent of the cap.

Limitations on bond issuance caused by volume caps could frustrate Congress' and the Administration's policy efforts where tax-exempt bonds are employed. For example, MRBs and IDBs — the authority for which would be extended in the President's plan — require volume cap allocation. Portions of bond issues from the enterprise and empowerment zones proposed by the President and passed recently by the House would count toward the volume caps. It is also clear that this committee believed that the volume caps frustrated the ability of this nation to develop and employ high-speed rail technology when it included in the Budget Reconciliation Act a provision exempting high-speed rail bonds from the state volume caps earlier this year.

There are several options that Congress could undertake to address the issue of volume caps. The most targeted approach would be to permit certain types of projects to be financed with tax-exempt securities outside of state volume caps. Many categories of projects, such as solid and hazardous waste disposal projects, wastewater treatment and collection facilities, community development and certain multifamily rental housing projects, and transportation facilities, represent essentially public uses of tax-exempt securities regardless of whether states or localities solicit private participation in providing the associated services. The most widely discussed means of legislating such a change is to define in the Tax Code a new classification of tax-exempt securities known as "public-activity" bonds, which would encompass the above uses of proceeds. In general, public-activity bonds could be issued without restriction regardless of the level of private participation as their underlying benefit would be directed to the public at large. PSA recommends such an approach in exempting public uses of private-activity bonds from state-wide volume caps. At the very least, the volume caps should be indexed for inflation to ensure the borrowing capacities of states do not erode over time. A third alternative would be to allow states to share unused cap allocation with other states that

[5]If states do not use their entire cap in a given year, they may designate the remaining cap authority for specific uses in future years. This so-called carryforward allowance must be used within three years. It is important to consider carryforward allowance when examining volume cap usage because many states, knowing that planned future projects will require substantial cap allocation, reserve cap allocation as carryforward to be combined with annual volume cap in future years.

exhaust their cap.[6] However, this approach presumably would involve significant administrative burdens.

Tax-exempt Financing for Public Power Authorities

At a hearing last month, the Subcommittee heard testimony on H.R. 2026, the Renewable and Energy Efficiency Incentives Act of 1993 introduced earlier this year by Congressman Jim McDermott.[7] PSA commends the creative efforts of Congressman McDermott in drafting legislation to provide tax incentives for the development of clean, efficient and renewable energy resources and to promote energy conservation. H.R. 2026 contains tax provisions which would encourage the development and use of new and promising energy technologies, such as solar, wind and geothermal. However, there is one provision of the bill to which PSA strongly objects.

As a means to offset partially the revenue-losing provisions stated above, and as a means to discourage the use of older energy technologies, Section 302 of H.R. 2026 contains a provision which would restrict the ability of municipal power authorities to continue to provide low-cost power to their customers. The bill would eliminate the ability of public power providers to issue tax-exempt bonds to finance new coal, oil or nuclear energy facilities. Although it might appear that such a provision would encourage providers to invest in newer technologies, in fact, the ultimate result would be higher electricity costs for millions of Americans and a distortion in the electricity market favoring investor-owned utilities over municipal providers.

Many public power systems are dependent on older technologies to provide service to their customers due to geographic or economic conditions. Alternative energy technologies are simply not readily available to many municipal providers. Sanctioning municipal providers for not investing in renewable energy sources creates hardships for the customers of such facilities and places public power utilities at a disadvantage to investor-owned utilities, who would not be sanctioned under the bill. It is also not clear whether refurbishment for efficiency or environmental purposes of an existing facility would qualify as "new" investment and hence whether such activity would qualify for tax-exempt financing under the bill. If the bill prohibited tax-exempt financing for the refurbishment of existing facilities, it would prove particularly troublesome for public power entities. It is also unclear whether Section 302 would apply to refundings of outstanding high-interest rate debt. If it did, such a prohibition could result in tens of millions of dollars of unnecessarily high interest payments for public power authorities, especially given the current environment of historically low interest rates.

Section 302 of the bill also represents a dangerous legislative precedent in limiting the use of tax-exempt bonds for public purposes. The federal tax code contains a number of restrictions on tax-exempt finance where the ultimate beneficiary of the tax-exemption is a private entity. Traditionally, however, Congress has wisely chosen not to limit the use of tax-exempt finance for purely public projects such as schools, roads, parks, public buildings and public power facilities. Restricting the ability of local governments to finance municipal power systems through the tax-exempt market would represent a significant policy shift away from federal support for financing public capital investment. PSA is vehemently opposed to any such change in federal policy. On the contrary, strong arguments can be made that policies fostering greater partnership and cooperation among various levels of government in financing public investment are economically beneficial and warranted. PSA has long advocated such policies.

Again, PSA commends Congressman McDermott's goals of encouraging greater investment in cleaner and more efficient renewable energy technologies. However, we oppose Section 302

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[6] See item 20 of the tax-exempt bond proposals contained in the Subcommittee's Press Release #4 dated June 2, 1993.

[7] See item five of the natural resources proposals contained in the Subcommittee's Press Release #4 dated June 2, 1993.

of H.R. 2026. Restricting the ability of municipal power entities to use tax-exempt bonds to finance their capital investment would hurt the ability of public power providers to supply their customers with low-cost electricity. Also, because Section 302 would impose a tax-code restriction on public power utilities and not on investor-owned utilities, it would distort the market in favor of investor-owned providers. Finally, in limiting the use of tax-exempt debt for purely public investment, the provision would represent a significant federal policy shift away from support for state and local public investment and would create a troublesome legislative precedent. For these reasons, PSA opposes the provision. However, we look forward to working with Congressman McDermott to identify policy alternatives which would accomplish the goals of H.R. 2026 without limiting the ability of state and local governments to use tax-exempt bonds.

Also before the Subcommittee is a proposal by Congressman Richard Neal that would ease financing restrictions on power output facilities.[8] Under current law, if more than ten percent or $15 million of a bond issue benefits a private party involved with a public power output facility, the bonds issued are considered private activity bonds. Congressman Neal's bill would repeal the $15 million limit and permit greater financing flexibility in the provision of public power output services. PSA supports this provision and its goals of establishing equitable treatment for public power output facilities.

Tax-exempt Bonds and Revolving Funds

One proposal before the Subcommittee would exempt from municipal bond arbitrage rules bond proceeds used to supply the minimum required state match for federal revolving fund programs. Revolving funds are an excellent way to foster partnerships among federal, state and local levels of government. They also represent a means to leverage scarce federal contributions for state and local projects. The Environmental Protection Agency's (EPA's) wastewater treatment revolving fund program is very popular and has been successful in providing low-cost sources of funds for local communities to finance sewer systems. Many states use tax-exempt finance to provide the matching portion of the wastewater revolving fund capitalization or as a means of aggressively leveraging the federal contribution.

The most popular structure for leveraging wastewater revolving funds is where a state reserves all or a portion of the federal government's contribution as a reserve against a state bond issue. The proceeds of the bond issue, which can be as large as three to four times the size of the reserve, are then lent to communities. The cash reserve allows a state to obtain a higher rating on the bond issue than it otherwise would, thereby reducing financing costs to communities that benefit from the program. This form of leveraging is a model for Federal, state and local partnerships in this, an era of very limited governmental resources.

The principal limitation faced by states under this structure involves investment of the reserve funds. Generally, the reserve fund must be treated as bond proceeds for the purpose of investment yield under the tax-exempt bond arbitrage rules in Section 148 of the Internal Revenue Code. This means that states must restrict the yield that they earn on the investment of their reserves, even though the funds do not result from the proceeds of a bond issue. One way to encourage states to leverage their federal contributions to a greater extent and to expand indirectly the size of revolving funds would be to allow unrestricted investment of reserves that back revolving fund bonds. The proposal before the Subcommittee would, to an extent, accomplish this goal. Limiting the proposal to proceeds not in excess of the minimum required matching amount, as the proposal does, would reduce the revenue cost to the federal government and would serve to prevent arbitrage-motivated abusive transactions. PSA strongly supports the proposal.

Other Tax-exempt Bond Provisions

In addition to the proposals outlined above, the Subcommittee is considering numerous other proposals related to tax-exempt finance. The proposals generally fall into one of three

[8] See item 19 of the tax-exempt bond proposals contained in the Sucommittee's Press Release #4, dated June 2, 1993.

categories. Some focus on expanding the use of tax-exempt finance for targeted types of projects where there is significant participation of private entities in cooperation with state and local governments. A second group of proposals are designed to provide additional federal assistance for targeted groups that benefit from tax-exempt finance. A third group are designed to simplify or streamline the Tax Code as it relates to tax-exempt finance.

Among the first group of items before the Subcommittee are proposals to permit tax-exempt financing for spaceports; allow volunteer fire departments to borrow in the tax-exempt market to purchase ambulances and other equipment; allow Stanford University to use bond proceeds for a project to "earthquake-proof" campus buildings; permit tax-exempt financing outside of private-activity rules for basic research facilities owned by governments or 501(c)(3) organizations; allow the city of Kenosha, Wisconsin to use tax-exempt finance for certain redevelopment projects; expand tax-exempt finance for certain output facilities; allow tax-exempt finance for ground transportation projects associated with airports, docks or wharves; and permit tax-exempt bond issuance for the clean-up of contaminated industrial sites.

Included in the second category of Subcommittee items are proposals to expand the use of veterans' mortgage bonds for veterans of Desert Storm and others; to expand the use of MRBs for two-family homes in distressed areas, for cooperative housing, and for larger home improvement projects than under current law; to expand the private-loan test rule for certain housing bonds; and a transition rule for state student loan agencies with tax-exempt student loan bonds outstanding that may be adversely affected by the student loan reform proposals in the reconciliation bill.

For proposals such as the two groups described above, the principal policy question is whether a federal subsidy — or an additional federal subsidy, in the case of areas where tax-exempt finance is already allowed — is justified at all. Once Congress decides that federal involvement is justified and warranted, the question becomes whether a direct subsidy — a cash payment, for example — is desirable over an indirect tax subsidy, such as the use of tax-exempt finance. Strong arguments can be made that in many cases, tax-exempt bonds are the most effective and efficient way to provide federal assistance.

Municipal bonds have many important features. First, bonds allow state and local governments to pay for big-ticket projects over time as they are used. Second, because states and localities can issue bonds without any direct federal approval, decision-making for individual projects can be concentrated at the local level, where the needs and priorities of states and communities are best known. Third, the market mechanism associated with municipal bond issues ensures that only creditworthy projects get financed. After all, it is ultimately investors in municipal bonds who decide whether projects are financially sustainable.

The most important feature of municipal bonds, however, is that interest paid to investors by state and local governments is exempt from federal taxation. Because investors who buy municipal securities know that their interest income will not be taxed by the federal government, nor, in most cases, state government, they are willing to accept a lower yield on their investments. The tax-exemption reduces the interest rates paid by states and localities and permits issuers to finance projects more cost-effectively. The foregone federal revenue associated with tax-exemption represents a form of federal assistance for state and local governments. Because the amount of financing that results from tax-exemption exceeds the amount of foregone federal revenue associated with tax-exemption, municipal bonds permit federal policy-makers to leverage the federal contribution to state and local public investment. For these reasons, municipal bonds are often the best mechanism available to provide federal assistance to capital projects undertaken by state and local governments in cooperation with the private sector. The first two categories of proposals should be evaluated in that light.

The third group of proposals before the Subcommittee involves simplification or clarification of existing tax-exempt bond provisions of the Tax Code. The first of these would apply the two-year construction period arbitrage exemption for certain bonds issued after the TRA of 1986 and before the 1989 budget reconciliation act, when the exception was enacted. This

provision would potentially save issuers whose bonds are affected millions of dollars in arbitrage rebate costs. However, PSA has no formal position on this proposal.

The second provision would increase the percentage of private benefit permitted for governmental bonds. PSA is supportive of proposals which would improve the ability of states and localities to engage in public-private partnerships in financing infrastructure and other projects that have public benefit. While PSA feels the current ten percent rule is overly restrictive, the "public activity" bond described above meets the same policy goal in a more targeted manner.

The third and final provision in this category would extend the one-year "issue period" for projects that qualify for IDB financing if and when the IDB program is renewed. In his testimony before this Subcommittee, Assistant Secretary Samuels stated that this proposal represents "a sensible change" for facilities placed in service after June 30, 1993 because "the failure to extend the statutory sunset date has caused projects to fail to qualify" for IDB financing. For the same reason, PSA supports the proposal.

Other Issues

In addition to the tax-exempt bond provisions discussed above, this Subcommittee also has a proposal before it that would facilitate the creation of financial asset securitization trusts (FASITs). The bill, H.R. 2065, seeks to promote the establishment of pools of credit from the securitization of loans, trade receivables and other financial instruments in the same way that real estate mortgage investment conduit (REMIC) structures have provided pools of credit from the securitization of residential mortgages.

Securitization creates market liquidity, expands credit availability, and decreases the reliance of borrowers on bank credit. Securities resulting from FASIT legislation would be in demand by investors seeking structures tailored to their individual needs. PSA supports Congressman Hoagland's FASIT bill and his policy goal of widening access to credit, and urges its timely enactment.

Conclusion

The United States public finance system is undoubtedly a valuable tool for states and localities to use in paying for the nation's infrastructure needs. The municipal bond market permits states and localities to leverage scarce federal resources to a high degree. It is important that the policies being considered by this Subcommittee treat all institutions (e.g. non-profit colleges and universities and public power facilities) fairly vis a vis their public or private counterparts. Also, inflation should not be allowed to inhibit the ability of state governments to meet public needs through their responsible allocation of state volume caps.

The municipal market is now a very efficient marketplace, free of the abusive situations that motivated many of the changes in 1986. Now the municipal market stands ready to help the federal, state, and local governments finance much needed public investment. There seems to be agreement that our nation's transportation and environmental infrastructure need attention. Through proper targeting, the tax code can be modified to utilize fully the cost-effectiveness of the tax-exempt municipal bond market as a tool in meeting these policy goals.

Chairman RANGEL. Thank you, Mr. Putman.
Ron Pentilla.

STATEMENT OF ROY A. PENTILLA, EXECUTIVE DIRECTOR, MICHIGAN STATE HOSPITAL FINANCE AUTHORITY, AND MICHIGAN HIGHER EDUCATION FACILITIES AUTHORITY, LANSING, MICH., ON BEHALF OF THE NATIONAL COUNCIL OF HEALTH FACILITIES FINANCE AUTHORITIES

Mr. PENTILLA. Thank you, Mr. Chairman.

My name is Roy Pentilla. I am the executive director of the Michigan State Hospital Finance Authority, and the Michigan Higher Education Facilities Authority in Lansing. I want to thank you for the opportunity to appear before you today to discuss how current tax laws impact our ability to help reduce the cost of providing capital for health care providers through tax-exempt bond financing.

I am also here to represent the National Council of Health Facilities Finance Authorities. The council was formed for the purpose of promoting the common interest of governmental issuing authorities like ourselves, which provide tax-exempt capital financing resources for not-for-profit hospitals and health care facilities.

There are 23 members of our council. The council focuses its efforts on issues which directly affect tax-exempt bond financing for health care facilities.

The council has issued over 55 billion dollars' worth of health care bonds. As principal providers of capital for such facilities, the council recognizes its role in America's health care system.

The Hospital Finance Authority issues bonds in Michigan for health care facilities and the Higher Education Facilities Authority issues bonds for private, not-for-profit colleges in Michigan. The administration of the authorities is a 13-person staff with assistance from health care and investment and legal advisers.

We have issued about 4 billion dollars' worth of tax-exempt bonds. We expect to issue about $400 million this year. However, despite this volume, like many of our council members, we find it not possible to provide capital for some of America's neediest borrowers, the primary health care providers, the frontline of health care delivery in our States.

I am here to seek your support for a change in bank deductibility rule by adoption of activities which we believe will provide a better point of access to the capital markets for small institutions needing assistance, help borrowers reduce expenses and reduce the risk of bond default, and help reduce the level of revenue loss for the U.S. Government resulting from the inability to generate significant reduction in the cost of health care delivery.

We offer three strategies to do this. We feel that reducing defaults on nonrated bonds will lower the interest rates on the proceeds raised through bonds, and will lower the size of borrowings because of reduced bond issuance costs.

As you know, the Internal Revenue Code allows 501(c)(3) health care institutions access to the capital markets on a tax-exempt basis. This reduces the borrowing substantially for our health care institutions.

For example, the rates on our variable rate bonds are between 2 and 3 percent now; and our fixed rate bonds are about 5 to 6 percent. Thus for small, weak institutions, access to the tax-exempt market is very important in making the projects feasible for the health care institutions.

However, unfortunately the current law restricts bank deductibility to the smaller issuers and we as large issuers cannot use the bank deductibility feature for our small health care clients. Historically, banks have always been the purchasers of the small tax-exempt bond issues. However, if the small hospital tries to get financing through a large authority, the code prohibits that because the test applies to the issuer, and we as an issuer always issue more than $10 million.

However, if the test was applied to borrowers, well, then we would be able to accommodate the smaller borrowers. Another important piece of information was prepared by a report by Kenny S&P Information Services that noted over a 11-year period that 98 rated bonds and 628 nonrated bonds defaulted for approximately $8 billion. Approximately 76 percent of these bonds were for health care and industrial development bonds.

Further, almost 90 percent of all the nonrated defaults were less than $10 million. Finally, nonrated bonds issued to finance health care projects defaulted the quickest, within 43 months.

We believe this series of facts reflects a problem which exists because of the current tax law, specifically that health care bonds of less than $10 million are financed as a one-shot activity rather than a part of a formally structured, closely regulated programmatic approach. This is true because statewide issuers like ourselves are unable to provide the financing for these smaller borrowers.

We, therefore, seek your support for an alternative proposal, namely to change the current bank deductibility from an issuer test to a borrower test. States, like ourselves and other members of our council, have the expertise to provide the people power and the expertise to provide the capital and help the small issuers.

The local issuers lack the expertise. Ninety-five percent of the defaults have been from local issuers rather than state issuers.

In summary, we feel that the solution is to provide the test on a borrower basis and not an issuer basis. We all need your help to correct the current situation by providing a low cost financing option for small health care institutions in Michigan.

There are other issues we would put on the table but given the time, we would limit it to this particular one. The council remains committed to providing access to capital for this vital segment of health care providers. The council is ready and eager to assist the committee to formulate a viable solution to the problem.

Thank you for the opportunity to be here today.

[The prepared statement follows:]

TESTIMONY OF ROY A PENTILLA
MICHIGAN STATE HOSPITAL FINANCE AUTHORITY, AND
MICHIGAN HIGHER EDUCATION FACILITIES AUTHORITY

Mr. Chairman, Members of the Committee, my name is Roy Pentilla and I am Executive Director of the Michigan State Hospital Finance Authority and Michigan Higher Education Facilities Authority (MSHFA and MHEFA). I want to thank you for the opportunity to appear before you today to discuss how current tax law impacts on our ability to help reduce the cost of providing capital for health care providers through tax-exempt financing. I am also here to represent the National Council of Health Facilities Finance Authorities ("NCHFFA" or "Council") which was incorporated in 1987 for the general purpose of promoting the common interests of the governmental issuing Authorities which provide a tax-exempt capital financing resource for not-for-profit hospitals and health care facilities.

The Council currently consists of twenty-three members representing Health Care Finance Authorities in the following jurisdictions.

Arizona	Colorado	Connecticut
Idaho	Illinois	Indiana
Louisiana	Maine	Maryland
Massachusetts	Michigan	Missouri
Montana	New Hampshire	New Jersey
New York	North Carolina	Philadelphia
Rhode Island	South Dakota	Vermont
Washington	Wisconsin	

The mission of the NCHFFA is to preserve, promote and enhance the common interests and effectiveness of member Authorities through communication, education and advocacy.

The Council focuses its efforts on issues which directly influence the availability of or access to tax-exempt financing for health care facilities. In doing so, the Council recognizes that it represents the member authorities which are the tax-exempt bond issuers and does not represent specific hospitals or health care institutions. The NCHFFA members have issued over $55 billion of health care bonds.

The MSHFA assists hospitals to obtain financing for health care facilities. In many cases this is accomplished by the issuance of tax-exempt bonds and notes. MHEFA is charged with the responsibility to issue tax-exempt bonds for Michigan private not-for-profit colleges.

The administration of the Authorities is the responsibility of a full-time professional staff with the assistance of a highly qualified team of health care, investment and legal advisors.

MSHFA maintains excellent, full-time relationships with bond rating agencies, the State Department of Public Health, the Municipal Finance Division and the Department of Treasury, which assists a hospital in receiving the necessary approvals needed to complete a financing.

MSHFA also works closely with hospital administrators, legal counsel, auditors and feasibility consultants to determine the most appropriate method of financing for a hospital.

MSHFA is an established agency of the Michigan Treasury Department but it exercises its statutory functions independently of the State Treasurer.

MSHFA has issued in excess of $4 billion in tax-exempt bonds, with an expectation that we will issue in excess of $400 million in the next year. However, despite this significant volume we do not find it possible to provide capital access for some of the most important and neediest borrowers - the primary care health providers. This is the front line of health care delivery in many of our rural and urban areas. I am here today to seek your support for a change in the bank deductibility rule by adoption of activities which we believe will: (1) provide a better point of access to the capital markets for small institutions needing assistance; (2) help borrowers to reduce expenses and the risk of bond defaults; and (3) help reduce the level of revenue loss for the US Government resulting from an inability to generate a significant reduction in the cost of health care delivery. I am here to offer strategies which can immediately serve to reduce the health care costs in three respects: reduction in defaults of non-rated bonds, lower the interest rate on proceeds raised through the issuance of tax-exempt bonds, and lower the size of borrowings because of reduced bond issuance costs.

Health Care Borrowers and the Tax-Exempt Bond Market

As you know, the IRS code presently gives 501(c)(3) health care institutions access to the capital markets on a federal tax-exempt basis. This access substantially reduces costs of borrowing, which are eventually included in health care charges that are passed along to consumers and the health care reimbursement system. For borrowers, tax-exempt financing generally represents the lowest cost of capital. Thus, for smaller and financially weaker institutions, access to tax-exempt financing can often be the determinative factor in making a project financially feasible.

501(c)(3) institutions do not have direct access to the tax-exempt markets, but engage a governmental bond issuer like the Authority to act as a conduit on their behalf in the borrowing process. Unfortunately, current tax law restrictions on bank deductibility limit the ability of larger conduit issuers like the Authority to provide the most cost-effective financing for the many small 501(c)(3) borrowers who come to us with smaller projects.

The Role of Banks in the Small Tax-Exempt Market

Private placements with bank lenders represent often the only affordable financing option for small tax-exempt issues because the issuance costs associated with a public tax-exempt issue in an amount less than $5 million are generally too costly to be affordable to small health care borrowers. For these smaller issues, private placement of the debt with banks affords substantial cost savings. While a health care institution should never limit its search for capital to just bank financing, a thorough review of all options may indicate that this is the best or possibly only financing option available.

Thus, access to this bank lender market can often mean the difference between a timely, successful project, and having to delay delivery of necessary services.

Non-Rated Bond Defaults

In a 1993 report prepared by the Kenny S&P Evaluations Services and Kenny S&P Information Services it was noted that from January 1, 1980 to December 31, 1991, there were 98 rated and 628 non-rated municipal bond defaults totalling approximately $8.63 billion in defaulted principal amount. Approximately 76% of all non-rated defaults by dollar volume were on health care bonds (e .g. hospitals, retirement facilities, nursing homes) and industrial development bonds (e.g. hotels, factories, office buildings). However, health care bonds alone comprised approximately 46% of the total dollar volume of non-rated defaults. Further, almost 90% of all the non-rated defaults occurred on issues that were less than $10 million in size. Finally, non-rated bonds issued to finance health care projects went into default at a rate that was amongst the fastest of all non-rated defaults (43.75 months).

We believe that this appalling series of facts is reflective of a systemic problem which exists because of current tax law. Specifically, most of the health care financings in a principal amount of less than $10 million are financed as a "one shot" activity rather than as part of a formally structured, closely regulated programmatic approach. This is true because of the inability of large statewide issuers like our Authorities to provide cost-effective access to capital markets for small borrowers.

Currently tax laws regarding bank eligibility for small bond issues preclude many of Michigan's smaller health care institutions and colleges from placing tax-exempt bonds with bank lenders because current law restricts such placements to small issuers -- those which issue less than $10 million of bonds per year. This inability to use banks to purchase the tax-exempt obligations of small borrowers forces these borrowers to pay higher borrowing costs which, in turn, contributes to a higher rate of defaults for such facilities. We appreciate the inclusion of a provision in last year's H.R. 11 to raise the current limit on bank deductibility from $10 million to $25 million per issuer. This change, however does not adequately address the problem faced by issuers seeking to issue small tax-exempt obligations to benefit small borrowers because it still places limitations on such placements by issuer, rather than by borrower. This restriction limits state-wide issuers like our Authorities from making low-cost tax-exempt financing available to the many small health care institutions that could benefit from new borrowing. We are therefore seeking your support for an alternative proposal -- namely to change the current bank eligibility from a issuer test to a borrower test. We believe this change would (1) allow the Agency to better provide financing for small institutions needing assistance, (2) help borrowers to reduce expenses and the risk of bond defaults; and (3) possibly lose less revenue for the Government than the proposal embodied in HR 11.

The Problem with Present Tax Laws Governing Bank Deductibility

Bank lenders are usually only interested in purchasing tax-exempt bonds which, under the new 1986 tax act, are deemed to be "bank eligible" (i.e., bonds for which the carrying costs are deductible). Eligibility is based upon whether the issuer reasonably

expects to issue less than $10 million in tax-exempt bonds in that year. If the answer is yes, then "small issuers" can issue "bank eligible" bonds. Unfortunately, each year state-wide issuers like us will always issue more than the allowed limit of $10 million (or $25 million in HR 11) because the state-wide issuers issue obligations for many borrowers, large and small within the state. (Last year alone, for example, we issued over $500 million dollars in health care bonds.) Therefore, a hospital in Michigan that needs to borrow less than $5 million must either pay the increased costs of a public issuance (where that is even possible) or else use a small local issuer that will issue less than $10 million in that year (assuming such an issuer is even available.) The latter option prevents borrowers from taking advantage of the significant benefits of using a state-wide issuer.

State issuers like us and our council members possess the expertise needed to evaluate the availability of potential projects and design tax-exempt offerings which meet industry standards for safety and soundness. They have a staff of qualified finance experts who can assist in selecting the appropriate financing option, negotiate covenants and confirm pricing for each financing. They can also standardize the financing process with a high level of quality, making sure that small borrowers and projects receive good representation. State issuers can also do one financing for all projects a borrower may have within the state, thereby reducing financing costs. By applying the test to borrowers which are included in pools we would extend the advantage of pool financings to more smaller hospitals and colleges. These issuers are also knowledgeable about new financing techniques which they in turn offer their constituent borrowers, and remain involved with projects when problems develop after a financing is completed.

Many local issuers lack such expertise, with potentially harmful consequences for the borrower and the investing public. In the case of health care bonds, 95% of defaulted loans -- by both number of issues and dollars issues -- have been issued by local, rather than state-wide issuers. Moreover, in urban areas a qualified local issuer does not exist because the locality itself is likely to issue over the $10 million limit.

If a 501(c)(3) health care institution reasonably expects to issue less than the requisite dollar amount of tax-exempt bonds in the year of issuance, then its bonds should also be bank eligible regardless of the conduit issuers' activity on behalf of other unrelated borrowers in that same year. To penalize small health care institutions for using a large conduit issuer these borrowers are deprived of using the best or only plan of finance available -- direct bank lending.

The following subgroups of Michigan 501(c)(3) borrowers are particularly affected by this problem:

1. Health care institutions in larger urban areas where other capital needs by the city or special local authorities exceed the threshold for bank eligibility.
2. Health care institutions in smaller communities where the bonds could be bank eligible but where the city wishes to keep the capacity for its future capital needs.

3. Health care institutions wishing to use MSHFA as a conduit issuer for a bank eligible financing, but are precluded from doing so because of the volume of MSHFA's annual debt issuance.

The Solution

As it relates to conduit financings on behalf of 501(c)(3) health care borrowers, bank eligibility of tax-exempt bonds should only require a small borrower test -- not a small issuer test. This change will greatly improve the access to capital for smaller health care institutions and small private not-for-profit colleges with small capital projects by making tax-exempt financing available to all on an equal basis. More timely financings (often at a lower cost) will be completed, balance sheets will be improved and long-term creditworthiness of these institutions will improve. If Congress wants to assist small 501(c)(3) borrowers, this is an ideal clarification to be made.

We believe this material describes the problems and inequities that current law has created regarding bank eligibility to purchase bonds issued for small health care institutions in Michigan and our members states. We all need your help to correct the current situation by providing a low-cost financing option for small health care institutions in Michigan. We recognize that there are other issues, such as the limitation on advance refundings, and the definition of a health care institution that could also contribute to a reduction in the cost of health care throughout the country. We welcome the opportunity to address these and other related issues at a future date. Thank you for the opportunity to appear before you today.

Chairman RANGEL. Thank you.
Mr. Henderson.

STATEMENT OF ROBERT E. HENDERSON, PH.D., DIRECTOR, SOUTH CAROLINA RESEARCH AUTHORITY, COLUMBIA, S.C.

Mr. HENDERSON. Mr. Chairman, I am Dr. Robert Henderson and I currently serve as the director of the South Carolina Research Authority. I very much appreciate the opportunity to appear before the Subcommittee on Select Revenue Measures in order to express the urgent need to clarify the tax treatment of private activity bonds in relation to certain types of research and development facilities.

More specifically, I am requesting the subcommittee's consideration of an amendment to section 141(b)(6) of the Internal Revenue Code that codifies cooperative research exception to the private business use found in the legislative history of section 141. Currently, this exception provides that cooperative research agreements between universities and nongovernmental entities are not considered a private business use if they meet certain requirements.

Thus, research facilities that conduct activities falling within the exception could be financed with tax-exempt bonds. The amendment that I am calling for would seek to provide similar treatment for facilities owned by a State or local government, or by a section 501(c)(3) organization, and would be consistent with the National Cooperative Research and Development Act of 1984.

Mr. Chairman, for the record I am providing a draft of this proposed amendment. This amendment would lead to a much needed refining and strengthening of a longstanding Federal policy of promoting collaborative research between U.S. companies, universities, and other centers of research and development.

In addition, this amendment will provide such benefits at a minimal cost to the Treasury, according to the recent Joint Committee on Taxation estimates.

Mr. Chairman, over the entirety of my professional career I have been intimately involved in research and development from an industrial perspective. Prior to accepting my present position, I served as cofounder and president of Technology Development Corp.

In addition, I held the position of president of the Indianapolis Center for Advanced Research, as well as director of research for the Allison Division of General Motors. Over the years, I have witnessed an important transformation in terms of the way U.S. industry views R&D. Emerging from World War II, the United States was an unrivaled industrial giant that also enjoyed unhindered access to the largest, most lucrative market in the world, our own.

As a result, R&D was viewed as a matter of luxury for the biggest and most profitable companies, rather than as a necessity across our manufacturing base. As we are all aware, such days are gone forever.

The United States no longer holds a position of prominence as an unrivaled industrial leader. The revitalization of Japan and Western Europe, the homogenization of markets through the blurring of national boundaries, and the increase of air cargo as a means to

mitigate geographic advantages, have created an intense multinational competition for markets both at home and abroad.

All these factors have led to a reevaluation of the need for advanced research and development as a means of better positioning U.S. manufacturers for intense global competition. My message is simple. The driving factor behind the wealth and economic stability our Nation has enjoyed during the past 100 years has been directly tied to a strong industrial base.

If the nation as a whole hopes to continue to derive benefits from that industrial base, our emphasis and resources in the area of R&D must be enhanced. Consequently, we must look for every opportunity to create incentives that will lead to technology innovation.

I believe that our new President expressed a keen recognition of this trend through his announcement of an enhanced Federal technology policy on February 22 of this year. In this announcement, President Clinton outlined a strategy for greater government involvement in the field of research and development in order to strengthen America's industrial competitiveness, as well as to create higher skilled and higher wage jobs for American workers.

Mr. Chairman, I believe the adoption of this proposed amendment will assist in accomplishing this worthy goal. By clarifying the definition of private business use contained in the legislative history of section 141, we will enable a wider array of qualified R&D facilities to be financed with tax-exempt bonds.

Essentially, Congress will be eliminating an unnecessary tax inequity that is proving detrimental to the formation and stability of research entities sponsored by State and local governments or nonprofit organizations. A failure to accurately address this inequity will only send confusing and contradictory signals to all interested parties at a time when Washington is attempting to boost the Nation's competitiveness by encouraging the formation of as many nonfederally sponsored research organizations as possible.

In addition, we will enable U.S. companies to access R&D expertise housed in a facility operated by a State or local government, or a 501(c)(3) organization at a reduced cost. Most importantly, we will be sending a significant message to industry and the R&D community that the Federal Government is seriously attempting to produce the most conducive environment possible for sound research and development in this country.

For the reasons stated above, I strongly urge that such an amendment be fully considered and adopted as part of any overall tax measure approved by the full House Ways and Means Committee.

Thank you again very much for this opportunity to appear before your subcommittee.

Thank you, Mr. Chairman.

[The prepared statement and attachment follow:]

Robert E. Henderson, Ph.D.
Director, South Carolina Research Authority
Testimony before the House Ways & Means Subcommittee on Select Revenue Measures
July 13,1993

Mr. Chairman:

I am Dr. Robert Henderson and I currently serve as Director of the South Carolina Research Authority. I very much appreciate the opportunity to appear before the subcommittee on Select Revenue Measures, in order to express the urgent need to clarify the tax treatment of private activity bonds in relation to certain types of research and development facilities.

More specifically, I am requesting the Subcommittee's consideration of an amendment to section 141(b)(6) of the Internal Revenue Code that codifies the "cooperative research" exception to the "private business use" found in the legislative history of section 141. Currently, this exception provides that cooperative research agreements, between universities and non-governmental entities, are not considered a private business use if they meet certain requirements. Thus, research facilities that conduct activities falling within the exception could be financed with tax-exempt bonds. The amendment I am calling for would seek to provide similar treatment for facilities owned by a state or local government, or by a section 501(c)(3) organization and would be consistent with the National Cooperative Research and Development Act of 1984. Mr. Chairman, for the record I am providing a draft of my proposed amendment.

This amendment would lead to a much needed refining and strengthening of a long-standing federal policy of promoting collaborative research between U.S. companies, universities, and other centers of research and development. In addition, this amendment will provide such benefits at a minimal cost to the Treasury, according to recent Joint Committee on Taxation estimates.

Mr. Chairman, over the entirety of my professional career, I have been intimately involved in research and development from an industrial perspective. Prior to accepting my position at the South Carolina Research Authority, I served as co-founder and President of Technology Development Corporation. In addition, I held the position of President of the Indianapolis Center for Advanced Research, Inc., as well as Director of Research for the Allison Division of General Motors. Over the years, I have witnessed an important transformation in terms of the way U.S. industry views R&D. Emerging from World War II, the United States was an unrivaled industrial giant that also enjoyed unhindered access to the largest most lucrative market in the world -- our own. As a result, R&D was viewed as a matter of luxury for the biggest and most profitable companies, rather than as a necessity across our manufacturing base. As we are all aware, such days are gone forever. The United States no longer holds a position of prominence as an unrivaled industrial leader. The revitalization of Japan and Western Europe, the homogenization of markets through the blurring of national boundaries, and the increase of air cargo, as a means to mitigate geographic advantages, have created an intense multi-national competition for markets both at home and abroad. All of these factors have lead to a re-evaluation of the need for advanced research and development as a means of better positioning U.S. manufacturers for intense global competition.

My message is simple: the driving factor behind the wealth and economic stability our nation has enjoyed during the past 100 years has been directly tied to a strong industrial base. If the nation as a whole hopes to continue to derive benefits from

that industrial base, our emphasis and resources in the area of R&D must be enhanced. Consequently, we must look for every opportunity to create incentives that will lead to technology innovation.

I believe that our new President expressed a keen recognition of this trend through his announcement of an enhanced federal technology policy on February 22 of this year. In this announcement, President Clinton outlined a strategy for greater government involvement in the field of research and development in order to strengthen America's industrial competitiveness, as well as to create higher skilled and higher wage jobs for American workers.

Mr. Chairman, I believe the adoption of this proposed amendment will assist in accomplishing this worthy goal. By clarifying the definition of "private business use" contained in the legislative history of section 141, we will enable a wider array of qualified R&D facilities to be financed with tax-exempt bonds. Essentially, Congress will be eliminating an unnecessary tax inequity that is proving detrimental to the formation and stability of research entities sponsored by state and local governments, or non-profit organizations. A failure to accurately address this inequity will only send confusing and contradictory signals to all interested parties at a time when Washington is attempting to boost the nation's competitiveness by encouraging the formation of as many non-federally sponsored research organizations as possible. In addition, we will enable U.S. companies to access R&D expertise housed in a facility operated by a state or local government, or a 501(c)(3) organization at a reduced cost. Most importantly, we will be sending a significant message to industry and the R&D community that the federal government is seriously attempting to produce the most conducive environment possible for sound research and development in this country.

For the reasons stated above, I strongly urge that such an amendment be fully considered and adopted as part of any overall tax measure approved by the full House Ways and Means Committee.

Thank you again for this opportunity to appear before your subcommittee.

AN AMENDMENT

To the Internal Revenue Code of 1986 to clarify the treatment of bonds used to finance certain governmentally owned research and development facilities for purposes of determining the limitations on private business use.

(a) IN GENERAL.—Subsection (b)(6) of section 141 of the Internal Revenue Code of 1986 (defining private business use) is amended by adding at the end thereof the following new subparagraph:

"(C) CLARIFICATION OF COOPERATIVE RESEARCH ARRANGEMENTS.—

"(i) IN GENERAL.—Research and development activities at governmentally owned facilities conducted pursuant to cooperative research and development agreements between governmental units and nongovernmental persons shall not be taken into account under subparagraph (A), if—

"(I) no nongovernmental person participating in the cooperative research and development agreement is entitled to preferential use of any product of the research and development activities (including any patent or license), and

"(II) the research and development activities have general application as opposed to an application to a particular product for the purpose of commercial exploitation on a preferential basis by the nongovernmental person.

Subclause (I) shall not apply if such nongovernmental person has a non-exclusive royalty-free license to use such product, purchases the license or other right to use such product at a competitive price determined at the time the product is available, or obtains the results of research and development activities otherwise disseminated to the public on a nondiscriminatory basis.

"(ii) RESEARCH AND DEVELOPMENT ACTIVITIES.—For purposes of clause (i), the term 'research and development activities' means any activities in the areas of health, environment, engineering, manufacturing and other technology, artificial intelligence, computer science, or the traditional sciences involving 1 or more of the following purposes:

"(I) Theoretical analysis, experimentation, or systematic study of phenomena or observable facts.

"(II) Development or testing of basic engineering techniques.

"(III) Extension of investigative findings or theory of a scientific or technical nature into practical application for experimental production and testing of models, prototypes, equipment, materials, and processes.

"(IV) Collection, exchange, and analysis of research information.

"(iii) GOVERNMENTALLY OWNED FACILITIES.—For purposes of clause (i), facilities owned by 501(c)(3) organizations shall be treated as governmentally owned."

(b) EFFECTIVE DATE.—The amendment made by this section shall apply to bonds issued after the date of the enactment of the Tax Reform Act of 1986.

Chairman RANGEL. Thank you, Dr. Henderson.
Mr. Arndt.

STATEMENT OF AUREL M. ARNDT, GENERAL MANAGER, LEHIGH COUNTY AUTHORITY, ALLENTOWN, PA. ON BEHALF OF NATIONAL LEAGUE OF CITIES, ET AL

Mr. ARNDT. Good morning, Mr. Chairman. My name is Aurel Arndt. I am general manager of Lehigh County Authority, which is located in Allentown, Pa., and which provides water and wastewater services to 13 municipalities in our county. It is my pleasure to present this testimony on behalf of the coalition of State and local government officials interested in the preservation of tax-exempt financing.

We look forward to working with you on these items on today's agenda and we strongly encourage and support the development of a long-term investment bill that will include other tax-exempt bond provisions that are critical to infrastructure and other State and local capital financing needs.

In addition to the four focal points of my testimony today, we also want to encourage you to adopt H.R. 13, the Tax Simplification Act of 1993, which contains tax-exempt bond provisions which are supported by State and local government officials. We recommend one clarification related to the definition of investment type property, which we will provide to committee staff.

The first point I would like to address is the current bank deductibility limit. Current law permits banks to take an interest—80 percent interest deduction for bonds issued by small governmental issuers and small 501(c)(3) issuers.

Such bonds are eligible for the bank interest deduction if the issuer does not issue more than $10 million on an annual basis. Prior to 1986, this deduction was available for all bonds held in a bank's portfolio.

Traditionally, banks have been major purchasers of tax-exempt bonds. In 1985, banks held 35 percent of the total outstanding tax-exempt debt; at year-end 1992, their holdings were only 8.5 percent. That reduced role threatens greater market volatility, less liquidity, and higher borrowing costs.

Increasing the bank interest deduction limit from $10 million to $20 million will provide relief for a large number of issuers that account for only a small percentage of the total volume of tax-exempt bonds. If the limit is increased, small issuer borrowing costs will be reduced because governments will no longer have to pay higher interest rates to attract bank capital.

This change would also—should also be supported because it will reduce the amount of tax-exempt debt issued; it will provide more stability to the municipal bond market; it will encourage bank investments in municipal bonds, which I would note are one of the least risky investment options available to banks; it will promote bank investments in local communities; and it will promote better management of local debt issuance.

Our organizations also support a provision to extend the bank interest deduction to bonds issued by a statewide authority, or as part of a bond pool for small issuers. It is notable that in 1992 the House and Senate passed legislation that contained an increase in

the bank interest deduction. Also in 1992, the Senate provided for the exception for statewide authorities.

Finally, we support amending the small issuer arbitrage rebate exception provision in H.R. 13 to $20 million. This small-issuer limit should be $20 million in the interest of simplicity and consistency in the Tax Code. And we believe that the eligibility requirements for both exceptions should be comparable, providing the small-issuer benefit to both taxing and nontaxing governmental entities.

Second, I would address the issue of private use. The Federal Tax Code impedes the financing of true governmental projects, inappropriately classifies some publicly owned and operated facilities as private activities, and prohibits financing in which appropriate private use of the facilities being financed can materially assist in the efficiency of providing the public service.

This occurs because of the rules that have been set forth to distinguish a governmental bond from a private activity bond. Private activity bonds are defined as securities issued by State and local governments where more than 10 percent of the facility being financed is for a business use and more than 10 percent of the debt service on the bonds is derived from the payments from private users.

In general, the law provides that private activity bonds are taxable, but the Tax Code enumerates certain private activities that are eligible for tax-exempt financing. The present law creates private activity situations in cases where rents and other charges are levied, including those related to governmentally owned and operated infrastructure facilities.

My testimony contains two examples, which I will leave to the written record. While there are several possible options to address this situation, we believe that modifying the present law definition to increase the 10 percent private benefit test is the most limited approach. But it is an important first step.

This change is desirable because it does not permit abusive transactions for tax-exempt financing for privately owned facilities; it promotes economical arrangements; and it does not create an unfettered right of State and local governments to pass the benefits of tax-exempt financing to projects not serving a public purpose.

In a related matter, I would also note that there is a $15 million limitation on tax-exempt public output bonds. Those related to facilities where you have publicly owned electric and gas facilities.

In these instances, we believe that that limitation is not supported by a public policy justification. It is discriminatory and it encourages practices that are not economically sound.

Finally, in addressing the matter of volume caps, in recent years volume cap limitations have precluded the financing of necessary and worthwhile projects in many States. Beginning in 1988, these caps were lowered to the greater of $50 per capita or $150 million.

This reduction was based on the incorrect assumption that MRBs, mortgage revenue bonds, and IDB, small issue industrial development bonds, would expire at the end of 1987. Our organizations believe that the best way to solve this volume cap limitation is to index the caps for inflation retroactive to 1988.

The volume cap limits have never been adjusted for inflation, or to reflect the continuation of the MRB and IDB programs. This problem does not solve the volume cap problem, it merely takes some of the pressure off and provides a mechanism for the volume cap to keep pace with rising costs and increased needs.

Finally, Mr. Chairman, I would again express my gratitude for the opportunity to address this committee. I must also point out, however, that there is no proposed legislation to address a very, very significant problem to the tax-exempt bond community, and that is the issue of arbitrage, relief from the arbitrage rebate requirement.

Thank you.

[The prepared statement follows:]

Testimony

of

Aurel M. Arndt
General Manager
Lehigh County Authority
Allentown, Pennsylvania

on behalf of

National League of Cities
Government Finance Officers Association
U.S. Conference of Mayors
Association of Metropolitan Sewerage Agencies
American Association of Port Authorities
American Public Power Association
National Association of Counties
National Association of Elementary School Principals
Municipal Treasurers' Association
Council of Infrastructure Financing Authorities
American Planning Association
International Bridge, Tunnel and Turnpike Association

concerning

Tax-Exempt Bond Provisions

presented to

Subcommittee on Select Revenue Measures
of the
House Ways and Means Committee

July 13, 1993

Introduction

Mr. Chairman and members of the Subcommittee, my name is Aurel M. Arndt. I am the General Manager of Lehigh County Authority in Allentown, Pennsylvania. The authority is a governmental entity that provides water and wastewater service to thirteen municipalities in Lehigh County. It is my pleasure to present this testimony on behalf of a coalition of state and local government officials interested in the preservation of tax-exempt financing. We look forward to working with you on the items on today's agenda and we strongly encourage and support the development of a long-term investment bill that will include other tax-exempt bond provisions that are critical to infrastructure and other state and local capital financing needs.

We urge you to include in any future tax legislation the items identified in this testimony. We also encourage the adoption of H.R. 13, the Tax Simplification Act of 1993, which contains tax-exempt bond provisions that are supported by state and local government officials. One clarification is recommended in that bill having to do with the definition of investment-type property, which we will provide to committee staff.

Item 9: Increase the Current Law Bank Deductibility Limit

Current law permits banks to take an 80 percent interest deduction for bonds issued by small governmental issuers and small 501(c)(3) issuers. Bonds issued by such issuers are eligible for the bank interest deduction if the issuer does not issue more than $10 million in volume on an annual basis. Prior to 1986, this deduction was available for all bonds held in the banks' portfolios.

Traditionally, banks have been major purchasers of tax-exempt bonds. However, they are no longer because of the 1986 changes in the bank interest deduction. In 1985 banks were invested in 35 percent of total outstanding tax-exempt debt; at year-end 1992, they held only 8.5 percent. Their reduced role in the tax-exempt market threatens greater market volatility, less liquidity and higher borrowing costs.

Increasing the bank interest deduction exception annual limit from $10 million to $20 million will provide relief for a large number of issuers that account for only a small percentage of total volume in the municipal market. If the bank interest deduction limit is increased, small-issuer borrowing costs will be reduced. These governments will no longer have to pay higher interest rates to attract bank capital. This change also should be supported because it will

- reduce the amount of tax-exempt debt issued because of lower interest rates on the bonds sold to the banks,
- provide more stability to the municipal bond market by eliminating excessive dependence on individual investors,
- encourage bank investments in municipal bonds which are one of the least risky bank investment options,
- promote bank investments in local communities, and
- promote better management of local debt issuance because small issuers will be able to issue $20 million every other year rather than having to issue $10 million annually.

Our organizations also support a provision to extend the bank interest deduction to bonds issued by a statewide authority or as part of a bond pool for small issuers. In 1992, the House and

Senate passed legislation that contained an increase in the bank interest deduction. In 1992, the Senate provided the exception for statewide authorities.

Finally, we support amending the small-issuer arbitrage rebate exception provision in H.R. 13 to $20 million. Both small-issuer limits should be $20 million in the interest of simplicity and consistency in the tax code. And, we believe that the eligibility requirements for both exceptions should be comparable, providing the small-issuer benefit to both taxing and nontaxing governmental entities.

Item 16: Private Benefit for Governmental Bonds

The federal tax code impedes the financing of true governmental projects, inappropriately classifies some publicly owned and operated facilities as "private activities" and prohibits financings in which appropriate private use of the facilities being financed can materially assist in the efficiency of providing public services. This occurs because of the rules that have been set forth to distinguish a "governmental" bond from a "private-activity" bond.

Private-activity bonds are defined as securities issued by state and local governments where more than 10 percent of the facility being financed by the bonds is for a business use (business-use test) and more than 10 percent of the debt service on the bonds is derived from payments from private users (security-interest test). In general, the law provides that private-activity bonds are taxable, but the federal tax code enumerates certain private activities that are eligible for tax-exempt financing.

The present law definition sweeps into the private-activity bond category those bonds issued to finance facilities whose cost is charged to users in the form of rents and other user charges. This includes bonds for public facilities, including governmentally owned and operated infrastructure facilities. Let me illustrate the problems created by the present law with two examples.

Example 1: If a government wanted to rent out surplus office space in a government office building to a private firm and that space exceeded 10 percent of the total available space in the building and the rent received from the private tenants secured more than 10 percent of the outstanding debt, the bonds issued to finance the government office building would not be eligible for tax exemption. The private use would result in the bonds being categorized as private-activity bonds. However, since government office buildings are not on the list of private-activity bonds eligible for tax-exempt financing, the bonds would not qualify for tax exemption.

Example 2: If a government issues bonds to finance the expansion of the public sewer system and one occupant of an industrial park in the city will be using 11 percent of the extension's capacity and pays an amount equal to 11 percent of the debt service on the bonds, the entire bond issue will be categorized as a private activity. These bonds are eligible to be issued on a tax-exempt basis because "sewers" are a purpose for which private-activity tax-exempt financing is permitted. However, the bonds would be subject to the state volume cap because only certain private-activity bonds issued for exempt facilities are not subject to the cap. And, they would carry a higher interest rate because the are subject to the alternative minimum tax.

There are several possible options for dealing with the bond definition problem. Modifying the present law definition to increase the 10 percent private benefit test is the most limited approach, but it is an important first step. This change is desirable because it

- does not permit abusive transactions or permit tax-exempt financing for privately owned facilities,
- promotes economical arrangements where issuers realize supplemental revenues to augment the tax-exempt purpose of the facility, and
- does not suggest an unfettered right of state and local governments to pass the benefits of tax-exempt financing to projects not serving a public purpose.

The purpose of the proposed change is to provide governmental issuers with additional opportunities to enter into public-private partnerships in the use and operation of governmental facilities. In addition, the change reduces the compliance costs that have been incurred since the enactment of the 1986 tax law to ensure that incidental private use does not jeopardize the availability of tax-exempt financing for a project.

We would note that the proposed elimination of the five percent unrelated and disproportionate use test in H.R. 13 is an important complement to this provision.

Item 19: Repeal the $15 Million Limitation on Tax-Exempt Public Output Bonds

In addition to the 1986 reduction of the private-use limitation from 25 percent to 10 percent, the federal tax code also provides that for certain output facilities--public power and public natural gas generation and transmission facilities--the private-use limit is the lesser of 10 percent or $15 million.

Private-use restrictions limiting the benefits available to private parties from publicly financed facilities are based on sound and appropriate public policy considerations. However, the restrictions should apply equally to all governmentally financed and operated facilities.

The special $15 million private-use restriction that applies only to publicly owned electric and gas facilities is not supported by any public policy justification. It may force local governments that provide generating and transmitting facilities to have their surplus capacity sit idle rather than having it sold to others in order to avoid the private-use limitation. This provision should be repealed because it is discriminatory and it encourages practices that are not economically sound.

Item 20: Volume Caps

In recent years, volume cap limitations have precluded the financing of necessary and worthwhile projects in many states. In 1986, statewide volume caps were set at the greater of $75 per capita or $250 million. Beginning in 1988, the caps were lowered to the greater of $50 per capita or $150 million. This reduction was based on the incorrect assumption that state and local governments' authority to issue Mortgage Revenue Bonds (MRBs) and Small-Issue Industrial Development Bonds (IDBs) would expire at the end of 1987.

Our organizations believe that the best way to solve volume cap limitation problems is to index the caps for inflation, retroactive to 1988. The volume cap limits have never been adjusted for inflation or to reflect the continuation of the MRB and IDB programs. The proposed change does not solve the volume cap problem, it merely takes some of the pressure off and provides a mechanism for the volume cap to keep pace with rising construction costs and increased financing needs. This change will ensure financing for necessary facilities that will produce jobs and needed housing and will finance environmental clean-up.

Mr. Chairman and members of the subcommittee, I appreciate this opportunity to address certain bond provisions. I must point out that there is no proposed legislation to address a very significant tax-exempt bond problem. Our organizations strongly support relief from the arbitrage rebate requirement.

Chairman RANGEL. Let me thank this panel for some well thought out proposals and certainly some very popular proposals. Under the rules we are working now, the House Members of Ways and Means and the Senate Finance Committee could not attach anything to the President's bill. And so therefore the Chairman of the House Ways and Means Committee, Mr. Rostenkowski, thought that we could hold hearings on miscellaneous provisions that were not allowed in the President's budget. If we could pay for them, then we could report out some of these things in a separate bill. Most of the items that you are talking about are costly.

Have any of you considered how to pay for these provisions? We have to come up with the funds to pay for these provisions. And so naturally politics being what it is, the most popular ones that cost the least are the ones that we might put on the suspension calendar. But given the costs—I understand yours, Mr. Henderson, is retroactive? What theory of research and development would retroactivity be useful?

Mr. HENDERSON. Let me answer your question. This is a clarification of definition of the research and development. So that there have been some cases where R&D programs have gone ahead and have not been allowed tax-exempt status.

Insofar as I am concerned, we could get this clarification through, I think you could do without the retroactive nature of it. But when you clarify something, there is going to be some inequity in the past based upon the fact that there has been a lack of clarity on the part of the IRS with respect to the definition of research and development. That is what I am saying, that this is a clarification in terms of the definition of research and development.

Chairman RANGEL. We don't have any—not that I think that citizens should have to come with revenue raisers if they come here with equity, but I just would want you to know, that is the problem that we face. We are going to have to hurt somebody in order to raise the money.

Mr. ARNDT. Mr. Chair, in response to your question, for instance the issue of bank deductibility, there is a consequence, a cost side which the public ultimately does bear in the fact that the lack of the bank deductibility does result in higher interest rates on those issues that do not qualify for that type of financing.

Chairman RANGEL. I wish we had the luxury of scoring things like that, but we just have to project how many people would take advantage of this deductibility and a possible loss of revenue. But anyway, I think that is our problem. But I would want you to know that that is an additional burden we carry.

Mr. PUTMAN. Mr. Chairman, I would also like to state that the PSA historically has very strongly supported deficit reduction. And particularly as it includes revenue raisers.

So we would be more than happy to work with the committee to search out those revenue raisers to offset some of these things. However, I would like to point out that the issues that we have raised have made a very efficient market more efficient by leveraging limited dollars that the Federal Government has available to implement many of its own programs that it has requested of State and local governments to do.

So we believe that we have enhanced local government's ability to support these programs on much smaller revenues. For example, the revolving funds take a significantly lower percentage of Federal support for waste-water treatment as compared with 75 percent under the old 208 program.

So we think we have made a very efficient use of these. I think one of the things that has to be addressed is what are the priorities of this country and how do we address them on a State and local government basis, particularly as it relates to the environment, education, and the inner cities and how we rebuild it and make transportation efficient. So we think we have done something in that regard.

Chairman RANGEL. If the right and moral thing could be scored, it would make our job much easier. But your problem is going to be when you pick out those savings that you think are best for the Nation, that there is somebody that is going to believe that the country can't live without them.

You are not thinking about low-income housing credits, are you?

Mr. PUTMAN. No, sir. No, sir, definitely not, sir.

Chairman RANGEL. OK. Let me thank this panel.

I have to go vote and the committee will resume in 10 minutes.

[Recess.]

Mr. KOPETSKI [presiding]. The subcommittee will return to order.

On our fifth panel today, we have Mr. Donald Smith, the executive director of the Western Commercial Space Center from Lompoc, Calif.; Edward O'Connor, executive director of the Spaceport Florida Authority; and Jon A. Mangis, director, Oregon Department of Veterans' Affairs.

Well, we have Jon here. Jon, you get more time. In the interest of time I would like to introduce Mr. Mangis. He is here to testify on the qualified veterans mortgage bond issue. It is H.R. 1289 which I and other members of the subcommittee have introduced.

The bill would cost about $2 million over the 5-year period assuming a bond volume cap at $300 million per State. I think there are ways to refine this so that the cost impact is lower.

But Mr. Mangis comes from the great State of Oregon. He is the director of our Department of Veterans Affairs. He himself is a veteran, having served in the Vietnam conflict.

After returning from the service, he completed his education and joined the Oregon Department of Veterans' Affairs. He worked for over two decades on issues that affect those who have served in our armed forces.

As a director, he has succeeded in making the department more efficient and cost-effective. We had some very difficult times in Oregon and Mr. Mangis was instrumental in helping us help lead the legislature in the State out of some very difficult problems.

I welcome you, Jon, to the hearing today and look forward to your testimony.

We do have the 5-minute rule here. Applies to everybody, it seems, including Members, so we are all being treated equally. If you would like to begin your testimony.

Before we do that, my colleague from Florida, Mr. Bacchus, is here, and I think he wanted to make some introductory remarks as well.

Welcome, Jim.

STATEMENT OF HON. JIM BACCHUS, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF FLORIDA

Mr. BACCHUS. Thank you, Mr. Chairman. And may I take this opportunity to thank you publicly for your strong support of the space program and the space station which is important not just to my district, but to our entire country, as you well know.

I am here today to introduce a friend and colleague of mine who shares our interest in the future of the space program and especially in the development of commercial spaces in industry to benefit all of this country. Throughout our Nation's history, the Federal Government has had the foresight to encourage the development of emerging means of commerce such as railroads, seaports and airports. I am here today in the hope that we can convince you to think of spaceports in the same way as you do these other means of transportation.

I believe we must view launchpads and rockets as the 21st century equivalents of railroads and trains, highways and automobiles, airports and airplanes, ports and steam liners. At minimal cost to the Government, but to the great benefit of the commercial space industry, we can provide bonds issued for the construction of space infrastructure with the same tax-exempt status we grant currently to similar airport and seaport bonds.

As members of this panel will tell you, such tax-exempt treatment is vital to the modernization of our outmoded space transportation infrastructure and the survival of the launch industry in a more competitive environment. A decade ago, Mr. Chairman, we had 90 percent of the commercial market in world space. Today we have the world lead, but only 30 percent of the market.

The bill that we are asking for, the exemption we are asking for, is probably one of the least expensive that you will hear about in the testimony before this subcommittee. The cost to the Government would be $19 million over 5 years. And that is million with an "M." This is something that would certainly benefit my State, but it would benefit many, many other States as well.

There are 33 States in the national association in favor of this bill. They have endorsed this unanimously. We have representatives from several States here today. To testify on behalf of this is a true pioneer in the commercial development of space, Mr. Edward O'Connor, who is the executive director of the Spaceport Florida Authority, which is the first State agency in the country created to encourage space enterprise.

This is something in which the State of Florida and the taxpayers of Florida have invested their own dollars, and, of course, private dollars are invested as well. Mr. O'Connor's expertise stems from 30 years of experience in the area of space, including 25 years in the Federal Government—a key role in the aftermath of the Challenger accident, I might add—3 years in the commercial space industry, and 2 years in State government. I am sure you will find his testimony enlightening and I thank you for your time.

Mr. KOPETSKI. Thank you, Jim. I should say as well that the reason that I am so supportive is because you are a great teacher. And I recognize the value of exploring space for all of our Nation, in

fact, the entire planet, and clearly your work in this has been noticed on the floor and within the halls. The fact that we have a viable space program is due to your efforts and I certainly appreciate it. And I know our great grandchildren, as well.

Mr. BACCHUS. Thank you, Mike.

Mr. KOPETSKI. But I am going to go to my constituent first.

Mr. BACCHUS. I would certainly advise that, Mike.

Mr. KOPETSKI. Thank you. Jon, welcome.

STATEMENT OF JON A. MANGIS, DIRECTOR, OREGON DEPARTMENT OF VETERANS' AFFAIRS

Mr. MANGIS. Thank you, sir.

For the record my name is Jon Mangis, and I am the director of veterans affairs for the State of Oregon. Today I appear before you on behalf of the veterans living in the States of Alaska, California, Texas, Wisconsin, and my home State of Oregon. I am here to support H.R. 1289 amendments that seek the authorization to issue qualified veteran mortgage bonds.

Prior to the 1984 Tax Reform Act, each of those provided low-interest mortgage loans to veterans residing within their boundaries. The Oregon Veteran Loan Program began with the encouragement from the U.S. Congress as a thank you to those brave men and women serving this Nation during World War II. It was to be a short-lived program, but America went to Korea, and Oregonians amended their constitution to make these men and women eligible for State veteran home loans.

Then it was Vietnam, and Oregonians again voted to change their constitution to make Vietnam veterans eligible. Then came 1984, and Congress legislated tax reform, stating that any qualified veteran must have entered the service prior to 1977 or they cannot benefit from the proceeds of qualified veteran mortgage bonds.

But American servicemen and women did not go away in 1977. Americans went to Central America, Grenada, Lebanon, and 2 years ago the Middle East. Today we have sent Americans to Somalia and Macedonia, and I don't know where they will be sent in the future. Americans, including Oregonians, have died in the service for this great Nation since 1976, yet according to paragraph 4, section 143(l) of the code, these men and women are not veterans. Your colleagues in the House of Representatives and the United States Senate amended 38 U.S.C., establishing veteran status for post-Vietnam veterans.

Yet if you live in Oregon, Alaska, California, Texas or Wisconsin, you are not considered a veteran because of a Tax Code provision that limits veteran status to those who served prior to 1977. The Oregon program, and I am sure the other State veteran loan programs, are questioned daily on why a post-Vietnam veteran cannot obtain a State veteran home loan, a fact only recently made worse when Congress extended Federal VA home loan eligibility to reserve military and naval forces.

The Oregon program has provided a major economic impact in my home State by providing low-interest loans to our veterans. During Desert Storm, our Oregon legislative assembly was ready to submit legislation to Oregon voters to extend eligibility to post-Vietnam veterans, until I asked them to table it. I explained that

until the United States Congress changed their eligibility status and the code, their actions would only create more confusion and hard feelings among Oregon veterans.

Historically, individual States have provided recognition for their veterans since the very beginning of this country. Five States created veteran home loan programs, all in existence prior to 1984. Most of these programs were created with the encouragement of your colleagues in 1943, 1944 and 1945, as they worked on a GI Bill of rights. Almost every State in this Nation responded with a variety of programs, but for us it was a State veteran home loan.

These programs are important to the economic well-being of the five States. Through the process of building, sale, and purchase of single-family residences, they generate millions of taxable dollars to the State and Federal Treasury, a fact generally not taken into consideration by congressional staff when they do their revenue estimates. I am here today to ask you, one, to eliminate the requirements of 143(l)(4), paragraph A, to allow veterans who served after January 1, 1977, to be eligible to obtain mortgage loan financing from qualified veteran mortgage bonds.

And two, to eliminate the 30-year requirement to allow veterans to apply for financing more than 30 years after leaving active service. As the immediate past president of the National Association of State Directors of Veterans Affairs, I ask for their support in this issue; and many of the committee members here, or who were here today, probably received letters from their home States.

Today we have a national resolution supporting these changes by the American Legion, the AmVets, Disabled American Veterans, and this year at the national convention we will receive supporting resolutions from the Veterans of Foreign Wars of the United States, and the Vietnam Veterans of America. Other organizations taking the issue under consideration are the Paralyzed Veterans of America, the Military Order of the Purple Heart, and the Marine Corps League.

I have provided written testimony and attached to the testimony is a copy of H.R. 1289 introduced by Congressman Kopetski, and also some of the history of the primary tax law requirements affecting qualified veteran mortgage bonds. I appreciate your willingness to listen to me and hopefully I can answer any questions that you might have.

Thank you.

[The prepared statement and attachment follow:]

STATEMENT OF

JON A. MANGIS, DIRECTOR
OREGON DEPARTMENT OF VETERANS' AFFAIRS
STATE OF OREGON

BEFORE THE

SUBCOMMITTEE ON SELECT REVENUE MEASURES
COMMITTEE ON WAYS & MEANS

WITH RESPECT TO

LEGISLATION AFFECTING QUALIFIED VETERAN MORTGAGE BONDS

WASHINGTON, D.C. JULY 13, 1993

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE:

On behalf of the veterans of the State's of Alaska, California, Texas, Wisconsin and Oregon I wish to thank you for inviting me to participate in today's important legislative hearing.

The issue that I address is that of eligibility to participate in State Veterans Home Loan programs funded through the proceeds of the sale of Qualified Veteran Mortgage Bonds.

Historically, this Nation and its many States have always provided for veterans disabled in service to their country and for their widows, their orphans.

During and shortly after World War II the U.S. Congress was working on the G.I. Bill of Rights -- and all of you are familiar with that, and the benefits that this Nation reaped by making education available to millions of returning service men and women.

At the same time the federal government encouraged the many states to come up with their own "welcome home" to those who served. And they did.

States created and executed numerous programs that have helped veterans -- right up to the present: State war bonuses; state education and apprenticeship programs; counseling; conservatorship, veteran (soldier) homes, etc.

Some states went so far as to create STATE VETERAN HOME LOAN programs. All to assist the veteran obtain low cost housing financing -- all somewhat different in construction; all, today, manage their programs within the guidelines for Qualified Veteran Mortgage Bonds outlined in Internal Revenue Code of 1986.

Section 143(l)(4) of the Internal Revenue Code of 1986 defines "Qualified Veterans" as those who entered active duty prior to January 1, 1977.

It also requires that the "Qualified Veteran" use his/her entitlement within 30 years of date of separation from active duty.

The above restrictions placed in the "Code" in the Tax Reform Act of 1984, must have assumed that Vietnam was the last conflict that American men and women would be sent to by their government.

Unfortunately, we have seen these men and women sent to Latin America, Grenada, Lebanon, and thousands upon thousands were sent to fight in Desert Storm.

I remember the rush of patriotism that enveloped this country when the mobilization began, and the sympathetic rush of pro military and veteran legislation introduced to support these men and women.

I also remember how quickly that support went away when that action was over and all veteran legislation was placed on the back burner.

And today, Americans are in Somalia and Macedonia.

If the United States never sent any Americans into foreign conflicts, I would have no problem supporting the cut off date of January 1, 1977. But today, I submit these restrictions are totally unfair to the thousands of veterans who served after Vietnam.

In 1990, I asked the five states who are authorized to issue Qualified Veteran Mortgage Bonds to meet in San Francisco. I told them that we must stop acting individually on what we ask our Congress to do to help our programs and that we must, as a group, prioritize our needs. We did and the top two issues that affect our programs equally are the issues I speak of today:

A. Eliminate the requirement of Section 143(l)(4)(A) so as to allow veterans who commenced service on active duty on or after January 1, 1977 (Post '76 veterans) to be eligible to obtain mortgage-loan financing from proceeds of tax exempt Qualified Veteran Mortgage Bonds.

B. Eliminate the requirement of Section 143(l)(4)(B) -- (the 30-year requirement), to allow veterans to apply for financing more than 30 years after leaving active service.

There are, obviously, more "wishes" -- but we as a group said that the provisions above were the most important to the veterans of our states.

Legislation was introduced in the 101st Congress to address these issues, but died with the cease fire of Desert Storm.

We continued to work. I asked Congressman Mike Kopetski from Oregon if he would help us. After many discussions, he introduced H.R.1289.

Individually, and as a group of five states, we appreciate his assistance and encouragement. We went to work to try to obtain cosponsors for H.R.1289. To date, we have 33 cosponsors. We will get more.

As a group, we met again in January and April 1993. We wanted to develop possible alternatives that would reduce or eliminate any revenue loss to the Department of Treasury. I believe that the Joint Committee has our proposals through Congressman Kopetski's office.

We are hoping for favorable consideration from you regarding changes to the "Code" that we are discussing today (Section 143(l)(4)(A) and (B).

We are often told that you cannot get anything from Congress that includes a revenue loss. I have yet to understand why only a loss is computed and is not offset by revenue gains. Our program causes housing to be built and houses to sell on the market with the tax exempt dollars becoming taxable income to those who receive these dollars as wages, for service and supplies, etc.

As the immediate past president of the National Association of State Directors of Veterans Affairs I enlisted the support of my associates in other states to contact their Congressional delegations and ask for their support for H.R.1289. And they did. It was unselfish support on their part because their states had nothing to gain. I want to publicly thank them. I hope you received one of their letters of support for these changes.

I also have supporting national resolutions from the American Legion; the American Veterans of World War II, Korea and Vietnam (AMVETS); The Disabled American Veterans; and Military Order of the Purple Heart. This year we will obtain national resolutions from the Veterans of Foreign Wars of the United States and the Vietnam Veterans of America.

I urge you to support these changes to Qualified Veteran Mortgage Bonds in the same spirit that your colleagues of 1944 and 1945 caused these programs to be created. When we as a Nation learn to live in a society that does not put Americans in conflict; then these programs will ultimately die on their own.

I wish to thank you for your consideration and allowing me an opportunity to appear on behalf of veterans from Alaska, California, Texas, Wisconsin and my home state of Oregon.

I will be pleased to answer any questions.

103D CONGRESS
1ST SESSION

H. R. 1289

To amend the Internal Revenue Code of 1986 with respect to the eligibility of veterans for mortgage revenue bond financing.

IN THE HOUSE OF REPRESENTATIVES

MARCH 10, 1993

Mr. KOPETSKI (for himself, Mr. SENSENBRENNER, Mr. STARK, Mr. YOUNG of Alaska, Mr. ROHRABACHER, Mr. WYDEN, Ms. FURSE, Mr. DEFAZIO, Mr. WILSON, Mr. DE LA GARZA, Mr. GONZALEZ, Mr. FROST, Mr. GOODLING, Mr. TEJEDA, Mr. EDWARDS of Texas, Mr. CHAPMAN, Mr. SARPALIUS, Ms. E.B. JOHNSON of Texas, Mr. BRYANT, Mr. COLEMAN, and Mr. MCHALE) introduced the following bill; which was referred to the Committee on Ways and Means

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A BILL

To amend the Internal Revenue Code of 1986 with respect to the eligibility of veterans for mortgage revenue bond financing.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

That (a) paragraph (4) of section 143(l) of the Internal Revenue Code of 1986 (defining qualified veteran) is amended to read as follows:

"(4) QUALIFIED VETERAN.—For purposes of this subsection, the term 'qualified veteran' means

any veteran who meets such requirements as may be imposed by the State law pursuant to which qualified veterans' mortgage bonds are issued."

(b) The amendment made by subsection (a) shall apply to obligations issued after the date of the enactment of this Act.

O

History of Primary Federal Tax Law Requirements/ Changes Affecting Qualified Veterans' Mortgage Bonds

Description	Primary Requirements/Changes
Mortgage Subsidy Bond Tax Act of 1980 (Section 103A)	* Bonds must be in registered form.
	* No Advance Refunding of Mortgage Subsidy Bonds permitted.
	* No refinancings of existing mortgage loans permitted.
	* Bonds must be General Obligations of the State.
	* "Substantially all" (90%) of the Bond proceeds must be used to provide residences to veterans.
Tax Reform Act of 1984	** Definition of "Qualified Veteran" provided.
	** Eligibility must be used prior to 30 years from date of separation from active service.
	* Establishment of Federal Bond Issuance Cap.
	* State Veteran Program needed to be in existence prior to June 22, 1984.
Temp. Reg. 1.103 A-2	* Informational Reporting Requirements to be filed with the IRS.
Tax Reform Act of 1986	* 95% or more of the net proceeds must be used to provide residences to veterans.
	* Permitted yield on veteran loans reduced from 1.5% to 1.125%.
	* No yield on "nonpurpose" investments can be retained above the yield of the bonds (rebate to Federal Government or borrowers).
1989 Tax Exempt Bond Arbitrage Regulations	* Specifies methodology for computing rebates (future value calculations).
1990-1992 Unsuccessful attempts at Congressional Law Changes (101st & 102nd Congress)	* S. 777 and H.R.1250 opened eligibility criteria to the authority of the individual States.
1993 - H.R. 1289 (Attachment H.R.1289)	** Current - speaks to definition of qualified veteran and 30-year rule.

Mr. KOPETSKI. Thank you, Jon. Your entire statement will be made a part of the record.

Before we go to the questions, I want to hear from the remaining members of the panel.

Mr. O'Connor, welcome.

STATEMENT OF EDWARD A. O'CONNOR, JR., EXECUTIVE DIRECTOR, SPACEPORT FLORIDA AUTHORITY

Mr. O'CONNOR. Thank you, Mr. Chair. It is a pleasure to be able to speak to you today about an issue I think is very important, not only to the State of Florida, but also to the Nation. I represent the Spaceport Florida Authority as executive director. The Spaceport Florida Authority is a State agency established in the same manner that you would establish an airport authority.

My organization was established 3 years ago in recognition that we were losing a good portion of our commercial space program to overseas providers of launch services. The trend was exceedingly bad.

In the early years of our space program, the United States was clearly the leader. It was providing launch services for the commercial marketplace. The early communication satellites that were launched and supported worldwide, developed a network of television, radio, telecommunication services. Those launches were based on U.S. technology.

Several years ago, though, we made a conscious decision in this country that we were going to help other nations with technology. We engaged in a considerable amount of technology transfer to the Europeans and they developed a European space agency and they went and developed a launch site in French Guiana where they have produced a tremendous number of launches. Launches from French Guiana now exceed the number of commercial launches we have in this country.

We provided this technology assistance with no expectation of a payback, but there was, I believe, an expectation on the part of our country that we would continue to invest in our commercial space efforts here in the United States. Following the Challenger accident, executive directives were issued saying that we would no longer support commercial space efforts with the orbiter fleet and through NASA commercial space activity. In turn, such efforts were devolved to the Air Force and they were given this effort as an ancillary duty to support, in addition to their normal military launch activity.

The Air Force has done a tremendous job in supporting those activities, but with the decreasing Defense Department budgets, we now see an agency that, although tasked with providing some of these commercial services, is unable to make the basic investment in infrastructure that is required. I would like to relate to you just a little personal experience on this issue.

When I first started in the Air Force in 1962, it was at Cape Canaveral Air Force station, launching rockets. I can go out there tomorrow, next week, the week after, and I will see the very same equipment being utilized in 1993 to support commercial launch activities, block houses that have sand bags surrounding them because there has been no basic investment made in those facilities.

The Air Force has done an admirable job of trying to assure we have access to space, but it is not the most cost-effective and efficient access.

When you are looking at commercial activities, cost and efficiency become paramount issues. Working with industry, we have determined that private industry is not currently willing to invest together with State government in the same manner that they would invest with new airports or for new runways for existing airports. Tax-exempt bonds will provide an incentive, provide a mechanism, an understood mechanism to the investment community, for making fundamental investment in our launch infrastructure.

There are very few sites in the United States that can sponsor and support commercial launches. However, the great majority of the country is directly affected by commercial space launch activity. As evidenced in earlier testimony, representatives from 33 States have appointed by their Governors to the aerospace States Association. They looked at investment opportunities and mechanisms and have recommended that tax-exempt status be provided to spaceports.

The revenue estimate from the Joint Tax Committee for this activity is $19 million over 5 years, a fairly modest investment. The estimate is based on bonds that are not even issued today and therefore these are really a deferral of new revenues, not a loss of existing revenues. We feel that with this modest investment we can improve the launch sites and in turn the rest of the States will profit because that way we will have places from which to launch spacecraft and satellites.

I don't believe anyone doubts that space represents a part of our national transportation network at this time, and we can expect to see our technologies, our satellites, our communication systems, our navigation systems, proliferate if we provide access to space. Yet several major manufacturers, such as Motorola's iridium launch systems—77 satellites to be launched for communication—now look overseas for potential launch sites. Hughes, producing some of our best communication satellites, went to Russia and China, and soon may look to the Japanese because of the limitations in our launch facilities in this country.

State government has expressed itself by establishing spaceports, patterned on airports, and are looking forward to being part of a developing national infrastructure which will support commercial space activity. We need to be launching from this country, developing a better technology base so we can transition our jobs in this country from the defense sector to peaceful pursuits using commercial space as one of the avenues for improving transportation and overall economic well-being.

The State of Florida is looking at 55,000 jobs disappearing because of the base closures. Spaceport activities can help augment and offset some of these losses. We express our deep interest in your support in considering favorably our tax-exempt bond request.

[The prepared statement follows:]

TESTIMONY OF EDWARD A. O'CONNOR, JR.
SPACEPORT FLORIDA AUTHORITY

Mr. Chairman and members of the subcommittee, I thank you for the opportunity to appear before you on behalf of the State of Florida and Spaceport Florida Authority.

The Spaceport Florida Authority was created by Florida's Governor and Legislature to provide a unified direction for space-related economic growth and educational development, to ensure a stable and dynamic economic climate, to attract and maintain space-related businesses and programs suitable to the state, and to further the coordination and development of Florida's space industry.

The Spaceport Authority is a public corporation and political subdivision of state government. It was created as the sole regulator of commercial spaceports in the state, and is responsible for ensuring, through active cooperation with federal agencies, the space industry, and academia, that a supportive environment exists in Florida for the growth and continued development of space enterprise, including launch activities, other space business, research, and education. All non-shuttle launch complexes on Cape Canaveral are included within the Spaceport Authority's state-legislated territory.

The Spaceport Florida Authority Act (Chapter 331, Florida Statutes) extends state sales and use tax exemptions for commercial launch vehicles, fuels, and payloads, and empowers the Spaceport Authority to issue bonds to finance the development of space-related projects. These are the nation's first municipal space bonds, and they may provide an attractive alternative for financing costly space programs, including infrastructure, launch support facilities, launch vehicles, ground stations, payloads, orbiting platforms, and other spaceflight hardware.

Bonds issued by the Spaceport Authority, and all instruments securing the bonds, are exempt from taxation by the state or any local government. Through separate federal legislation, the Spaceport Authority is seeking to attain tax exempt status for bonds which finance the development of elements necessary to the operation of a spaceport--the same exemption currently extended to bonds used for airports or seaports.

With its focused charter and broad powers, the Spaceport Authority is capable of bringing together the resources, funding, and planning efforts of industry, government (both state and federal), and academia to maintain and improve our nation's capabilities to access space, and bolster the competitive position of the domestic commercial launch industry.

I am pleased to present the views of the state of Florida on the spaceport tax proposal that is one of the subjects of these hearings. The proposal benefits many states. I am here with other state representatives and elected officials to request that you support tax-exempt financing of spaceports. This legislation to amend the Internal Revenue Code of 1986 to treat spaceports like airports is an important means of accomplishing the objectives of the Commercial Space Launch Act. We must maintain our competitiveness in the commercial launch industry to preserve our leadership position in other space industry sectors. Our nation's commercial space launch industry needs support because it faces increasing competition from Europe, China, Japan, India, Australia and the former Soviet Union. These governments fully appreciate the strategic and economic advantages provided by developing their own launch systems.

PART ONE

For the past few years the U.S. commercial space industry has been going through a difficult transition. While the industry was built around, and continues to serve, federal agency needs, its relationship with the federal government often inhibits the pursuit and conduct of purely commercial business. While this statement simplifies the complex and necessary systems of oversight between government and industry, there is much that can be changed by government to further the development of this strategically important business sector.

The needs of U.S. space business can be served through proactive support from both state and federal governments. Being profit-motivated in an extremely competitive and costly industry, space companies are remarkably sensitive to the business environment that state and federal governments create. Technical assistance, tax policies, insurance requirements, and access to infrastructure all can have an immediate impact on the industry's ability to respond to market needs, and to react to market fluctuations.

The future of international space industry will be driven by a commercial demand for a presence in space by high technology businesses for their products, services, and research needs. Those nations able to provide low cost, reliable access to and from the marketplace/laboratory of space will control an industry destined to grow and mature well into the next century.

We must maintain our nation's leadership in space by encouraging, supporting, and improving commercial space transportation capability. To compete against other nations, which are clearly increasing their long-term emphasis on space technology and transportation, we must provide for sufficient modernization of infrastructure required to support our current stable of expendable launch vehicles.

The states have grown to recognize the importance of space and aerospace industry as being one of the last high technology areas where the U.S. has maintained an international leadership role. Like Florida, they also realize that the industry is in jeopardy of future dominance by our foreign competitors. Together with Florida, over 33 states are now involved in the Aerospace States Association (ASA), which is an organization of state delegates devoted to forming joint aerospace-related economic and educational programs and strategies, and supporting mutually beneficial aerospace policies and legislation in Washington.

PART TWO

Florida has taken several steps to improve the space industry environment by increasing university involvement, providing tax incentives and financing assistance, and creating an advocacy organization specifically to assist space enterprise. The federal government has also taken steps to encourage space industry by developing space policies and legislation which encourage its agencies to procure commercial services and hardware when feasible.
In keeping with the intent of these federal policies, Florida is supporting various other initiatives in Washington aimed at encouraging space enterprise. As noted, the amendment would make spaceport facilities eligible for tax exempt bond financing to the same extent as other transportation facilities, such as airports, docks and wharves. The description of a "spaceport" is very similar to an airport. A spaceport includes facilities directly related and essential to servicing a spacecraft, enabling spacecraft to take off or land, and transferring passengers or space cargo to or from the craft. The facilities

must be located at, or in close proximity to the launch site to perform these functions. To be eligible, the spaceport facilities must be owned by a governmental unit.

PART THREE

There is an immediate and growing need for improvement and modernization of our nation's existing space transportation infrastructure and capabilities. Although Cape Canaveral is perceived by many to exemplify the state-of-the-art in U.S. technology, today's commercial launch operators are increasingly concerned about their ability to meet launch commitments due to near-obsolete support infrastructure and equipment. This legislation will allow investments in developing and improving our commercial space infrastructure. We will be able to provide cost effective, reliable transportation to space. Without such access to space, we will lose out in the marketplace and lose an industry in which we have led the world. We strongly support the proposed amendment to the Internal Revenue Code of 1986 for the tax-exemption of spaceport bonds, and urge you to support such legislation.

The Spaceport Authority has committed to establishing a more competitive environment where space businesses have:

* Easy and economical access to launch and launch-support facilities.
* Enhanced capabilities for infrastructure and systems modernization.
* Access to facilities for payload development and preparation.
* Access to financial assistance and alternatives for infrastructure development.
* A mechanism for forming partnership arrangements with government and universities.
* An experienced pool of engineers, scientists, and other support personnel.
* Easy access to universities and research centers.
* Access to business incubators for small and entrepreneurial space-related firms.
* Strong support from federal, state, and local governments.
* Assistance and support for safety and environmental issues.
* An advocacy organization dedicated to providing support and assistance to space industry.

Together with industry, universities, and the federal government, the Spaceport Authority hopes to form lasting partnerships to satisfy our mutual needs, and increase our effectiveness in the world marketplace through teamwork and innovation.

As you may know, the cost of a single medium-class commercial launch is in the range of $45-70 million. That means the loss of a single commercial launch to an international competitor is a loss of $45-70 million to our nation's gross national product. It also means a loss of approximately 400 U.S. high tech jobs and a further imbalance of international trade in a segment of our nation's economy that has long been a leader in exports.

There are two pieces of good news. First, the international market for space transportation is expected to expand dramatically between the years 1994 and 2000. During that time, the U.S. satellite industry is currently projecting the need to launch more than 300 satellites. Although a smaller number of launches is actually expected to occur, the U.S. space transportation capability must be pushed beyond its current limits to meet this demand. The alternative is a continued erosion of U.S. market share.

The State Governments and Industry are now willing to work with the Federal Government to turn the tide and reclaim the nation's market share in the international space transportation industry. No longer is it necessary for the Federal Government to continue its full funding of the infrastructure that is necessary to support our nation's space transportation system.

Instead, State Governments -- including the State of Florida -- are willing to share the burden by investing in space transportation infrastructure. The reason that State Governments are willing to make this investment is to keep and to create high-paying, high tech jobs.

Because our nation's space launch capability is out of date and costly to maintain, the U.S. and its states will lose both revenue and jobs to our international competitors unless we begin immediately to modernize. State Governments, including the State of Florida, have already begun to invest in the nation's space transportation capability. During the past three years, Florida has invested more than $3 million in programs aimed at improving U.S. competitiveness in space transportation. And other states, such as Virginia, Alaska, California, New Mexico, and Hawaii are making similar investments. But the States cannot continue to do so without the Federal Government as a partner.

Industry has also begun to invest in our nation's space transportation system. For example, Minnesota's Honeywell corporation has made a $90 million investment in avionics systems to be used in existing and new launch vehicles. Thiokol Corporation of Utah has invested more than $40 million to develop a new rocket motor, the Castor 120. Other companies like Orbital Sciences Corporation, EER, American Rocket Company, International Microspace and others have also invested millions to enter the U.S. space transportation industry.

This proposed legislation is an action that will directly benefit the several states in which space transportation infrastructure is or may be located -- including Florida, Virginia, New Mexico, Alaska, and California. Depending on developments in launch technology and system performance, other states, including Texas, Hawaii, Alabama, Mississippi and Arizona may establish launch sites at some point in the future and are, therefore, strong supporters of this legislation. It is an action that will also benefit the states in which no infrastructure is located, but in which space transportation hardware is built -- including Michigan, Minnesota, Texas, Colorado, and Utah.

In part because of our aging infrastructure, U.S. satellite manufacturers increasingly turn to foreign launchers to transport their products to orbit. Growing numbers are petitioning for permission to use Chinese and Russian rockets.

Lastly, this proposed legislation will greatly assist us in upgrading our country's commercial space infrastructure at a minimal cost to the federal government. The current revenue estimate puts the cost of this measure at only $19 million over five years.

A 1992 National Research Council study called From Earth to Orbit, An Assessment of Transportation Options found that most U.S. launch facilities "*are in a deteriorated condition, particularly on the East Coast, and pose the potential for safety problems and schedule slips.*" These safety problems and schedule slips put a large cost burden on commercial launch companies that are trying to offer a competitively priced service. With regard to launch system improvements, the study concluded that "*no other space-related innovation would offer the country as much of a gain in capability as inexpensively and as quickly.*"

Scheduling Commercial Operations at National Ranges, a report prepared by USDOT's Office of Commercial Space Transportation in 1989, found that "*limitations in the physical plant at the [launch] ranges would continue to present a problem for the competitiveness of commercial users.*"

The National Space Launch Strategy (released in 1991) encourages state "*investment and participation in the development and improvement of U.S. launch systems and facilities.*" The Strategy also encourages "*the development and growth of U.S. private sector space transportation capabilities which can compete internationally.*"

Florida and several other states recognize the importance of maintaining a cost-effective means for U.S. access to space. Commercial space is a $4.7 billion industry in the U.S. It represents thousands of jobs and is one of the few industries where our nation has remained dominant. Cost-effective transportation to (and from) orbit is a prerequisite to the continued growth of all other sectors of the space industry.

In closing, we want to join together with the Federal Government to implement our program of infrastructure improvement. We ask for your full support for this tax exemption. It simply would allow states' spaceports to be eligible for exempt facility bond financing to the same extent as airports. As in the case of airports, the facilities must be owned by a governmental unit to be eligible for financing.

Let me again emphasize that this proposal will assist other states, including New Mexico, Alaska, Hawaii, Virginia, Mississippi, Texas, Utah, Alabama, and California who are contemplating or implementing specific space transportation infrastructure projects. These states and their programs would directly benefit from such a tax exemption program. Still other states, where launch vehicles, satellites and other components are manufactured, will receive an indirect benefit. Partly because of our infrastructure problems, our nation's launch sites have become chokepoints for space industry growth. If we can launch more rockets at less cost, then more satellites and rockets can be built, and more research and development can be conducted.

I thank you, Mr. Chairman and Subcommittee members, for the opportunity to speak to you today about this important issue.

Mr. KOPETSKI. Thank you very much for your testimony and your complete statement will be made a part of the record.

Mr. Donald Smith is an executive director of the Western Commercial Space Center from Lompoc, Calif. Welcome.

STATEMENT OF DONALD DAVID SMITH, EXECUTIVE DIRECTOR, WESTERN COMMERCIAL SPACE CENTER

Mr. SMITH. Thank you, Mr. Chairman, for allowing me to speak in support of tax exemption for spaceport bonds. I too have a detailed written testimony that I would like to submit for the record and with your permission I will provide you with a short oral summary.

I am Donald D. Smith, the executive director of Western Commercial Space Center, a nonprofit California corporation dedicated to developing a commercial spaceport at Vandenberg Air Force Base on the California central coast, and to promoting the creation of high-tech commercial space jobs throughout California.

As I am sure you are aware, California was the last to feel the effects of the current economic recession, but it is now the hardest hit with the loss of high-tech aerospace jobs approaching 200,000. This loss is expected to increase with the declining defense budget.

The development of a commercial spaceport at Vandenberg has a dual benefit for the United States. First, it will replace lost defense jobs at the lowest cost of conversion; and second, through dual use of existing launch and support facilities, help sustain our vital national security infrastructure.

The U.S. Government has invested billions of taxpayer dollars in two primary space launch sites, at Cape Canaveral in Florida and at Vandenberg Air Force Base in California, because they provide complementary, not competitive capabilities. If you want a space vehicle to go to the moon, explore the solar system, or be placed in a geostationary orbit, you would most likely launch to the east out of Florida.

To best view the earth, detect the weather, see the sun 24 hours a day, or cover the earth with a low Earth orbit constellation of communication or navigation satellites, you would launch to the south out of California's spaceport. What is a spaceport worth in terms of jobs and economic impact? I have two examples based upon Vandenberg Air Force Base.

The first involves the decline in high-tech jobs. From 16,000 people employed in 1986 to the present 9,000 employed at Vandenberg, the loss of 7,000 primary jobs has a ripple effect in the surrounding community of 150,000 people, thus doubling or tripling the overall loss. To turn this around, we must provide a commercial spaceport capability.

As the Los Angeles International Airport grew from the bean fields of the 1920s, through legislative actions including tax-exempt bonds, so too must the growth of the Vandenberg commercial spaceport be supported by tax-exempt financing.

The second example which illustrates the economic impact the Vandenberg spaceport has on the U.S. economy occurred in August 1991, when Motorola Satellite Communications Co. notified both McDonnell Douglas and the Air Force that its iridium satellite system of 66 satellites would not be launched from Vandenberg be-

cause of the too burdensome California regulatory and tax environment. This decision virtually eliminated U.S. launch vehicle companies from bidding on the $500 million in launches that are involved in the project and assured the French rocket company, Arianespace, of an additional half-billion dollars to add to its present $4 billion launch backlog.

Our organization was successful in having Motorola rescind this decision within 6 months through the combined efforts of city, county, and State governments, the U.S. Air Force, and 35 out of the then 45 California Congressmen. Today, McDonnell Douglas is negotiating with Motorola for these launches, having won the competition with Arianespace.

However, Arianespace still has 60 percent of the world's commercial space launch market. If Motorola is successful in raising $3.3 billion in foreign capital markets for their iridium implementation, an additional $1.5 billion will be spent in the United States for high-tech systems such as the 66 satellites. This $2 billion of nontaxpayer dollars invested in the United States is an example of but one of five satellite systems presently being developed by private companies.

However, if the launch vehicle business is lost to overseas competition such as France, Russia, and China, the satellite manufacturing business will soon follow. Low-cost commercial spaceports are vital to this new frontier industry.

The success in returning the Motorola business to California energized both Governor Wilson and the State legislature. Three bills have just passed the assembly and are waiting Senate action which support the California commercial spaceport.

A.B. 279 designates the Western Commercial Space Center as the California spaceport authority.

A.B. 485 establishes a commercial space office in the California Department of Transportation and designates the Western Commercial Space Center as the official recipient of commercial space grants.

A.B. 1313, Speaker Willie Brown's bill, removes the State sales tax from all products and services launched from Vandenberg's commercial spaceport.

Governor Wilson signed the California State budget early on July 1, just a couple of days ago, and released a statement identifying $300,000 in this very austere budget for the Western Commercial Space Center to develop the California space launch capability. I strongly urge you to approve Federal tax-exempt status for spaceport bond issues. This will create jobs in California and throughout the United States.

Thank you. I will be happy to answer any questions you have about California spaceport development.

[The prepared statement follows:]

STATEMENT OF
DONALD DAVID SMITH
EXECUTIVE DIRECTOR
WESTERN COMMERCIAL SPACE CENTER

Statement

Mr. Chairman, thank you for allowing me to testify in support of the proposed amendment to the Internal Revenue Code to clarify that publicly-owned commercial spaceports are eligible for exempt facility bond financing to the same extent as airports and seaports. I am Donald D. Smith, Executive Director of the Western Commercial Space Center. Our community-based organization is a non-profit California corporation dedicated to developing the commercial space capabilities at Vandenburg Air Force Base and throughout the State of California.

As I am sure you are aware, California is somewhat unique among the states, both in terms of geography and demographics. In the case of the 1990-1992 economic recession, while California was the last to experience the downturn, our state was hit harder and longer than all other states.

Thus, I am here today not only because the development of Vandenburg Air Force Base as a commercial spaceport makes economic sense from an existing assets utilization point of view, but also because the development of Vandenburg as the Western Commercial Space Center will mean jobs -- jobs for Californians, and jobs for America's emerging technology companies.

Mr. Chairman, before discussing the demonstrated economic benefit that the Western Commercial Space Center will bring to California, I think the Subcommittee would find it helpful if I were to briefly discuss the technical reasons that the $30 billion federal investment in launch facilities at Vandenburg should be utilized for a Western Spaceport.

As you may know, vehicles launched from California quite literally fly in a different direction than do vehicles launched from other spaceports. We launch to the South and normally orbit over or near the North and South Poles in what is generally referred to as a high inclination or polar orbit. If you want to go to the moon, visit the solar system or go into a geostationary orbit (where the old style communications satellites are placed) you will normally launch to the East out of Florida. However, if you want to view the Earth, detect the weather, have 24 hours a day sunshine on your spacecraft or cover the entire earth with a low earth orbit satellite communications system, then you would launch to the South out of California's spaceport.

What does all the above mean to your Committee? It means that California's spaceport is not a duplication of Florida's, but is complementary to it.

Mr. Chairman, I am here specifically to ask that you consider extending to California and to the other commercial space centers around the country, the same tax-exempt bond status previously granted to America's seaports and to our nation's airports when they were on the leading edge of American technological development in the 1920's and 1930's.

As an example of what I mean, I need only point out the experience of Los Angeles International Airport. In the 1920's, Los Angeles International Airport ("LAX") was a large collection of bean fields. Today, it is the hub of a number of airports, in the L.A. metropolitan area, primarily as a result of numerous legislative actions, including the granting of tax free bond financing. In the 1990's, we need the same tax free financing to develop the dual use capability of the military launch infrastructure in Florida and California.

Mr. Chairman, what is a spaceport worth to our community? It will mean high tech, high paying jobs to the people living around Vandenburg Air Force Base, an area with a population of over 150,000 people. The Vandenburg facility employed 16,000 people in 1986 and today employs about 9,000, a loss of 7,000 primary jobs which normally impact the community at the ratio of two or three to one in secondary jobs, thus doubling or tripling the overall job loss.

In terms of economic impact on the U.S. economy, in 1992 approximately $400 million in commercial space launch vehicle sales were reported by American companies. In that same year, over $500 million in future commercial launch vehicle sales were prevented from going to the French company Arianespace, which presently has a sales backlog of $4 billion and 60% of the world commercial launch vehicle market.

Mr. Chairman, the threat to America's commercial spaceport future is upon us. For example, in 1991, Motorola Communication Satellite Company notified both McDonnell Douglas and the Air Force at Vandenburg that due to California's existing regulatory and tax environment, the company would no longer consider Vandenburg as a viable alternative to the French polar launch site in French Guiana. This decision by Motorola assures the French launch company, Arianespace, of winning a major portion of Motorola's Iridium Communication Satellite program's launch requirements. With 66 satellites in Motorola's initial plan and including future maintenance and replacements, the Motorola decision will result in at least 10 launches at $50 million per launch for the French company. Thus, a half billion dollars worth of booster business will be lost to America.

California's spaceport group at Vandenburg has organized an effort to have Motorola reverse its decision on California and choose the Vandenburg Spaceport as its primary facility. I am pleased to tell you that through a series of actions by local organizations, cities, county and state governments, the U.S. Air Force and 35 Members of the California Congressional Delegation, Motorola has reversed its decision and has notified Governor Wilson that Vandenburg would be their preferred launch site. Today, Motorola is negotiating with McDonnell Douglas on the number of boosters and their cost.

If Motorola is able to raise the reported $3.3 billion in capital requirements for the Iridium System, not only will the U.S. receive $0.5 billion in booster business but over $1.2 billion in satellite manufacturing business which Lockheed Corporation has a contract to provide. Thus, over $2 billion of non-taxpayer funds will flow into the U.S. high tech space industry from just this one program alone. There are five other U.S. companies developing similar low earth orbit ("LEO") systems which should bring in an additional billion dollars to this burgeoning industry. U.S. spaceports are vital to the development of these programs in the U.S.; if the booster industry goes overseas, the satellite industry will soon follow.

As a result of the effort to return Motorola's business to California, both the California legislature and the Governor's office have taken steps to develop Vandenburg as a commercial spaceport. California state legislative bill AB 279, which will designate the Western Commercial Space Center as the California Spaceport Authority, recently passed the Assembly on a unanimous 70 to 0 vote, and is awaiting Senate Committee action. Bill AB 485, which will create a spaceport office in the California Department of Transportation and direct the appropriated federal and state space grant funds to the Western Commercial Space Center, also has passed the Assembly and the first Senate Committee with unanimous approval. Speaker of the Assembly Willie Brown's Bill AB 1313, which removes the state sales tax from all space products and services launched from Vandenburg, is awaiting final Assembly passage. Governor Wilson's press release upon signing the California State Budget early in the morning of

July 1, 1993, states "Governor Pete Wilson today signed the Budget Bill (SB 80) that includes $400,000 in funding for the nonprofit Western Commercial Space Center (WCSC). . . . The funds represent a commitment by government to work in cooperation with the aerospace industry to maximize existing U.S. launch and federal launch facilities that could support commercial space activities and enhance California's competitiveness." In addition, both Governor Wilson and Assembly Speaker Willie Brown, in a bipartisan effort, have written letters to NASA Administrator Dan Goldin endorsing our efforts to bring commercial space business to California.

I strongly urge you to approve federal tax exempt status for spaceport bond issues. With such a tax exempt status, private investment will flow into America's spaceport programs. As a result, jobs will be created and retained by America and our country will be able to maintain its lead in a vital 21st Century industry.

Thank you and I will be happy to answer any questions you might have about California's spaceport efforts.

Mr. KOPETSKI. Thank you for your testimony.

Before we move to the questions let me ask unanimous consent for the following requests. To include in the record at appropriate points Chairman Rangel's opening statement, Mr. Ford's statement, Mrs. Johnson's statement, and Mr. Matsui's statements. Without objection, so ordered.

Mr. Mangis, simply stated, the existing rule in the U.S. Code makes younger veterans ineligible to borrow from our State's program; is that correct?

Mr. MANGIS. Mr. Chairman, yes, if you assume an individual is 18 years old when they enlisted in the service, the average age would be about 34. From our point of view, the individual who needs the assistance obtaining home finance, the average Vietnam veteran is in their 40s today. Some of us are older.

Mr. KOPETSKI. Well, this certainly makes sense. Is it true that the principal reason that there are only five States that have these veterans housing bond programs is due to the fact that back in 1984 the law was changed to preclude States that didn't already have a program from starting one?

Mr. MANGIS. That is one of the reasons, sir. If the programs weren't in effect prior to June 22, 1984, they could no longer participate in the qualified veteran mortgage bonds. Another reason might be that to participate in this program they have to be a general obligation of the State. And a State may not wish to place its credit behind this type of a program. Five States have.

Mr. KOPETSKI. And so the five States that do, including Oregon, of course, didn't have anything to do with the other 45 not having a program?

Mr. MANGIS. No, nothing. Matter of fact, I still get inquiries from other States on how they would implement this type of a program. And I just send them a copy of the code.

Mr. KOPETSKI. Right. As you know, the Treasury has testified that it does not support expanding the qualified veterans mortgage bond program because it applies only to veterans in these five States. What are your thoughts on this limitation? Do you think it should be expanded, do you think it should remain the same, or should it be excluded or deleted from the code?

Mr. MANGIS. I think, this being my personal viewpoint, perhaps for the other five States, but as long as the United States continues to put people in uniform, then the States that have this program in effect should be allowed to provide housing for these individuals as a thank you for that service to their country.

Mr. KOPETSKI. There is currently a mortgage revenue bond program available for first-time home buyers who meet certain income requirements. Do you have any sense as to whether veterans in Oregon generally would be eligible for financing under that program?

Is that program failing to meet the needs of all or at least veterans in some manner?

Mr. MANGIS. Mr. Chairman, those programs that use private activity, bond cap, operate within the State to provide housing that meets certain needs. Some of those are low-income housing or multifamily housing. Our program has no restrictions on income, provides housing benefits or financing to individuals based on honor-

able service. And so you can be any age or you can be in any income level.

Mr. KOPETSKI. So some of these veterans may have too high an income to qualify for these other housing bond programs?

Mr. MANGIS. Yes, sir.

Mr. KOPETSKI. But maybe not high enough to quite get there yet to be able to go to the commercial market.

Mr. MANGIS. That is true.

Mr. KOPETSKI. OK. Thank you. I think Mr. Shaw has some questions.

Mr. SHAW. Yes, I do, Mr. Chairman. I would like to direct my comments to Mr. Donald Smith, and particularly Edward O'Connor, who is the executive director of the Spaceport of Florida Authority. In introducing him, I think it is important to note we hear so much about rocket scientists and what you have to be and not have to be as far as a rocket scientist to understand such things. Well, we do have a genuine rocket scientist that is here.

Mr. KOPETSKI. I always wanted to meet the guy.

Mr. SHAW. You got him. And that is an earned degree, I understand. And I say that with tongue in cheek, but it is the truth.

So I think that certainly speaks very highly of his testimony, which must be taken at face value. This is an extremely important issue to this country's commercial space transportation industry.

The tax-exempt status for spaceports facility bonds, this proposal which I have earlier introduced as a bill, will enable the United States to develop the infrastructure necessary for a competitive commercial space launch industry. This applies not only to spaceports themselves, but to the providers of launch services, and companies which manufacture and test launch vehicles and their components, as well as satellites and other payloads.

The proposed amendment clarifies that spaceports are eligible for exempt facility bond financing to the same extent as publicly owned airports, docks and wharves. This signal of Federal support is vital to the survival of the U.S. commercial space industry and our effort to maintain our competitiveness in the international marketplace.

Our Nation's newly completed commercial space launch industry faces increasing government-sponsored or subsidized competition from Europe, China, Japan, India, Australia, and, of course, the former Soviet Union. The U.S. share of this market is in serious decline. Foreign competition is capturing an increasing share of the international space launch industry in part because of the outdated condition or unavailability of low-cost U.S. facilities.

With the help of this amendment, and at an extremely low cost to the Federal Government, we can begin to rebuild our existing infrastructure as well as construct new launch and recovery facilities. To achieve the state of the art in space requires state of the art financing on the ground. The revenue figure that has been attributed to my bill is the same as the amendment; over 5 years its amounts to $19 million. That is for the entire 5-year period.

As you know, the scoring unfortunately doesn't take into consideration other things that would happen. I would certainly guess that the moneys would save the Federal Government in the exploration of space would far exceed the $19 million which in the Fed-

eral sense is not that substantial, particularly when you look at this as only what it costs in revenue for the exemption from taxation of these particular bonds.

The tremendous amount of investment that this envisions in the space industry is quite substantial. This is a very important amendment and I would certainly urge the committee to include it as a part of any type of tax bill which is going to come out of these hearings.

I thank you, Mr. Chairman.

Mr. KOPETSKI. You are welcome. Did you have any specific questions at this time?

Mr. SHAW. No.

Mr. KOPETSKI. OK. Mr. Hoagland.

Mr. HOAGLAND. Let me, Mr. Chairman, just briefly ask Mr. Smith if this Federal tax-exempt status were granted for a spaceport bond issues, would that be all the Federal support necessary to operate the California and Florida projects?

Mr. SMITH. Bond revenues wouldn't be used for operations. When you say operating the spaceport, those are different sets of funds. The bond revenues would be used to build the infrastructure for a facility specifically for commercial users. Presently, Vandenberg has the largest launch infrastructure of any free world spaceport, unbeknownst to most people in the United States. It also has the largest number of orbital launches conducted there.

Mr. HOAGLAND. Would Federal funds be needed to underwrite other aspects of the operation?

Mr. SMITH. It is the intent of the Air Force to develop dual use of some of their facilities. However, this would not support many of our commercial space requirements. As an example, Orbital Science Corp. has a Pegasus vehicle which they fly under the wing of a B–17 and under the belly of an L–1011. They would like to have a hangar built for this project and the U.S. Government would not build them that hangar. That would be done under some type of bonding arrangement.

Mr. HOAGLAND. Mr. O'Connor.

Mr. O'CONNOR. I would like to comment, if I might. Under the Commercial Space Launch Act, which was passed several years ago, a requirement exists under law that commercial launches be self-supporting, so there would be no other Federal money to support the operations of a spaceport. As an example in Florida or California, if you put a new facility on the Federal reservation, it would have separate electric meters, it would have separate water meters.

All the Federal services provided to that facility would be billed to the facility and in turn picked up by the commercial-user community. This is a process that is already in being used right now on the launch ranges and would would continue under that same requirement.

Mr. HOAGLAND. So it would be operated and funded completely independent of Federal dollars other than those lost by this tax expenditure?

Mr. O'CONNOR. That is right, it would be handled in the same way that you would rent a hangar or use a runway at a commercial airport. A commercial customer would come to a State agency with

a valid project that would augment our space launch capability in the commercial marketplace.

They would give a partial guarantee for the bonds through revenue. The State then in turn would issue a tax-exempt bond as is done with an airport-type bond. And in turn that would be used to finance the facility.

Mr. HOAGLAND. And what is the estimated revenue loss of this proposal?

Mr. O'CONNOR. $19 million over a 5-year period.

Mr. HOAGLAND. Mr. Smith, do you have——

Mr. SMITH. I had one comment. What we are trying to do in California is develop a Los Angeles International Airport type spaceport. Anyone who would use those facilities would pay their fair share of cost, just like Continental or American Airlines paying user fees at LAX. The same thing would happen to McDonnell Douglas, General Dynamics, Lockheed, and all the rest who would use the spaceport launch facilities.

Mr. HOAGLAND. Thank you.

Thank you, Mr. Chairman.

Mr. KOPETSKI [presiding]. Mr. Payne may inquire.

Mr. PAYNE. No questions.

Mr. KOPETSKI. Let me follow up with a couple of questions. How many spaceports are currently—are on the planning boards out in our Nation, Mr. Smith or O'Connor?

Mr. SMITH. We know of about five, I believe. Presently there are two in existence and there are three others that are semi-spaceports, Wallops Island in Virginia, and then there is White Sands Launching Range in New Mexico and Athenia Launching Range in Utah.

Of course, there have been launches out of Texas—Matagorda Island—and Alaska and Hawaii are both thinking of putting in spaceports. There are fairly significant funding requirements for developing those spaceports if we get a single stage to orbit or a vehicle is eventually developed, then any State would have access directly to space from a spaceport.

Mr. KOPETSKI. How long does it take to build one of these?

Mr. SMITH. Well, I started in 1959 at Vandenberg and it had been in existence for 2 years then and, of course, that is the age of our infrastructure out there, 35-year-old launch facilities. It could be done in 5 to 10 years, I would expect.

Mr. O'CONNOR. Quick follow up on that. If you look to the Department of Transportation which has done studies of the commercial marketplace showing the slow evolution of the marketplace, the Department would say that over the next 5- to 10-year period, which is a conservative forecast for this type of technology, that we have the potential for doubling or possibly tripling the number of launch activities.

If you separate that into how many launch sites are required, there are probably at most three viable spaceports in the financial sense. We feel that the marketplace, because spaceport authorities will look to the commercial launch companies to be the revenue source for their bonds, will probably self-limit itself to approximately three locations for the near term.

Hopefully though in the long term, beyond the 10-year horizon, we could see more space activities occur which could enrich the environment.

Mr. SHAW. Mr. Chairman.

Mr. KOPETSKI. Mr. Shaw.

Mr. SHAW. Yield to me for 1 second because there is an important point here that I would like to make. It could very well be argued that the spaceport is indeed an airport.

The problem that you get into when you are looking at the opinion of counsel on a municipal type bond issue is that the lawyers won't sign off on this approach because they understand that traditionally this could be called in and it could create a problem.

So the argument could be made that all we are doing is making a clarification of existing law. In order to be safe, we wanted to go back and to file this as a separate amendment to this bill so that we would have the revenue projections and everything else. But the argument certainly could be made that the law is already in that state.

Mr. KOPETSKI. How much, therefore, would a spaceport cost or how much bonding—how large bonds would one sell to build one of these?

Mr. O'CONNOR. Right now we are working with the U.S. Navy on a launch complex down in Florida for conversion to commercial use and our cost estimate right now is for the first phase of conversion to cost roughly $5 million.

Mr. KOPETSKI. That is conversion of an existing site?

Mr. O'CONNOR. Conversion of an existing site. Predominantly that is what is going to occur. If you look at Vandenberg, if you look at Florida, if you look at Wallops Island, look at Utah, even New Mexico as a potential launch site, we have existing Federal resources there that are underutilized, but there is no Federal program to augment them to support the commercial industry.

So what we are looking at as the predominant financing role will be the augmentation of existing facilities and conversion of facilities.

Mr. KOPETSKI. And how much—I mean, does the $5 million mean that you would be able to sell a launch?

Mr. O'CONNOR. At a cost of $5 million in Florida we would have one particular complex that would let us do the launch. If you looked at starting from ground zero, going from a clean piece of sand, or to an abandoned launch site, as an example at Cape Canaveral, we are probably talking about $25 million to do a complete facility for the small launch vehicles.

The types of spaceports we are talking about would not launch the big things like the space shuttle or the large Air Force Titans. That type of spaceport would cost millions and millions of dollars. We are talking about much smaller spaceport facilities to launch the small, new, innovative systems that are coming out of the horizon and that have already been invested in by private industry to reduce the cost of launches. It is basically providing launch pads for the smaller systems so private industry can use them.

Mr. KOPETSKI. So what size, for this one in particular, what size of bonds then would you be asking?

Mr. O'CONNOR. The first bonds we would probably go looking for as far as on site facilities would probably be in the order of $25 million.

Mr. KOPETSKI. I thought phase one was only $5 million.

Mr. O'CONNOR. That is for phase one. That is almost too small to issue a bond for. The State of Florida already has done quite a bit of funding internally for the spaceport.

We are doing part of that right now and we are looking at participation with other Federal agencies to bring that project about.

When we look though at the next phase, which is the true augmentation, pure commercial stand-alone capability, we would anticipate about $25 million. That is also supported by a Department of Transportation study that was completed in January of this year that says to add a launch facility for commercial purposes is about a $25 million cost.

Mr. KOPETSKI. What would be the term of the bonds?

Mr. O'CONNOR. The term of the bonds in all likelihood would be something in the order of 10 to 15 years. It seems that is the technology life of the project, and also is the appropriate financial horizon.

Mr. KOPETSKI. Why won't a combination or syndicate of people in this area, whether it is construction or whether it is in telecommunications, put together the moneys themselves to have a private venture here in the United States?

Mr. O'CONNOR. One of the difficulties with a private venture in many respects is—if you look at the limited launch sites we have in the United States, you have to have a large area around you that is completely clear because of the dangers incident with the launch activity. There are very few places where you can launch.

Therefore we have a natural limitation because of geography where you can do that.

From the State of Florida perspective, we feel it is good public policy that the launch facility be held in neutral hands and run like an airport, which in effect is the organizer of the consortia. We would work with several launch companies that are participating by backing the bonds for a launch site that satisfies all their needs.

Mr. SMITH. Could I give an example of that problem? Hawaii has been trying for the past 3 years to develop a spaceport and they have asked various private companies to come in and evaluate the potential. Bechtel Corp., one of the largest construction companies in the world, and Martin Marietta Corp. individually were asked to come in.

They evaluated the cost of developing the facility, which was somewhere between $1 and $5 billion and made the determination that they would never recover their initial investment in developing a project on Hawaii, so they have walked away from that project.

Mr. KOPETSKI. Thank you. Further questions from the committee?

I want to thank each of you. Your testimony has been very enlightening. Jon, we will see you at home.

Panel six, we have from the National Constructors Association, Michael Martello, chairman of the tax committee. In his other life

he is the assistant controller and manager of taxes, Bechtel Construction Co., San Francisco.

Also from the Associated General Contractors of America, Robert J. Desjardins, chairman, Tax and Fiscal Affairs Committee, and he is also executive vice president and treasurer, Cianbro Corp., Pittsfield, Maine.

From the Student Loan Interest Deduction Restoration Coalition, Paul Jung—I hope I pronounce that correctly—second year medical student, University of Maryland at Baltimore, and from the American Land Title Association, Irving Morgenroth, member, Government Affairs Committee, and he is also general counsel and executive vice president of the Land Insurance Title Co. in Philadelphia, which is located in the great State of Pennsylvania, I am told. Welcome.

We have this unique 5-minute rule and so all of your statements will be placed in the record in their entirety and we appreciate about a 5-minute summary of your testimony. Let's begin with Mr. Martello.

Mr. CARDIN. Mr. Chairman, before you begin, could I just take this opportunity to welcome Mr. Jung to the committee? He is a constituent of mine in Baltimore who came to my attention when I was interested in the deductibility of interest on student loans.

Mr. Jung presented to me a firsthand example of a person who has really been trapped by our current system. He is a medical student at the University of Maryland, second year, who will accumulate around 70,000 dollars' worth of debt. He is interested in going into preventive health care, a field that we desperately need, which will require a couple more years of training after that.

The amount of debt that he will accumulate in school will carry significant interest costs which, as you know, is not currently deductible. It was because of the impression he made on me when he was in my office that I followed through on this legislation, and also welcomed him to come to Washington to show us firsthand a person who has been caught by the current situation.

So I just really wanted to welcome him to the committee.

Mr. KOPETSKI. Mr. Cardin, the State of Maryland has taken some very innovative measures in the whole arena of health care.

Why don't we begin with Mr. Jung so that we can capture this testimony.

STATEMENT OF PAUL JUNG, SECOND YEAR MEDICAL STUDENT, UNIVERSITY OF MARYLAND AT BALTIMORE, ON BEHALF OF STUDENT LOAN INTEREST DEDUCTION RESTORATION COALITION

Mr. JUNG. Good afternoon, my name is Paul Jung. I am pleased to have the opportunity to speak on behalf of many thousands of students represented by the Student Loan Interest Deduction Restoration Coalition.

I am a second year student at the University of Maryland School of Medicine. On behalf of many individuals like me with significant student loans, I ask you to restore the tax benefit for educational debts.

I plan to enter a career in public health and preventive medicine. Board certification in this field requires a 3-year residency. During

my residency, I will be paying off a $90,000 debt while making $20,000 per year.

My monthly payments will be approximately $1,000 and cumulative interest in my first repayment year will be $7,000 or 35 percent of my resident's salary. This makes me really, really nervous.

When I finish my residency, I hope to work for the Federal Government and make approximately $40,000 a year. Thus, as a practicing physician, my debt burden will have a significant impact on my finances.

My situation is not unique. I have made a conscious decision to enter preventive medicine, a low-paying field. Many classmates of mine begin medical school with the intent of entering primary care; however, as their debt levels increase, they get just as nervous as I am and choose to enter higher paying specialties. I am not speaking only for health profession students, but for all students and their parents. There has been increasing reliance on loans to finance higher education because grants and scholarships have not kept up with demand. I could only afford medical school with loans and for many other students and parents, a loan is the only way to finance higher education. Our coalition members have examples about the impact of indebtedness in a number of fields.

One example is a single mother in her 30s who will need to borrow at least $25,000 to complete her undergraduate degree at a public university. This will have an impact on her postgraduation career and future education plans. The indebtedness problem is compounded when lower- and middle-income parents attempt to send several children to college at the same time.

This is especially a problem for parents who do not own a home or have sufficient equity in their home to take advantage of the home equity deduction for student loans.

This problem is also a concern for minorities, especially those seeking doctoral and health professions degrees. One university reports their minority student debt levels are 50 percent higher than average.

I believe that the bill introduced by Congressmen Cardin and Bunning would be a significant help to students and parents throughout the country. H.R. 1667 would provide a choice between an interest deduction or credit for student loan repayments. The potential benefit from the bill may not seem significant in terms of the numbers you are accustomed to seeing, but in my situation a deduction would be at least the equivalent of saving a month's rent and would probably save me over $1,200 in the first year when I finish my residency and begin working in public health.

Right now that is about 10 months' worth of groceries for me. H.R. 1667 is a reasonable, targeted approach that would provide this benefit for the first 4 years of loan repayment only. It is specifically targeted to middle and lower income taxpayers and would also help parents who borrow to finance a dependent's education.

A deduction insures that this benefit would provide the greatest assistance to those taxpayers with the highest debt. A tax credit would help nonitemizers.

H.R. 1667 builds upon legislation that passed Congress in 1992 but was vetoed, and it will help support the Nation's investment in higher education. I would like to point out that the Cardin-

Bunning bill would complement the National Service and Direct Student Loan proposals offered by the Clinton administration and now being considered in Congress.

Favorable tax treatment for student loans is important to economic revitalization and will immediately encourage investment in higher education and in our most important resource: People.

I want to thank the subcommittee for the opportunity to appear today and I will be pleased to respond to any questions you may have.

Mr. KOPETSKI. Thank you for your testimony.

[The prepared statement follows:]

TESTIMONY OF PAUL JUNG
STUDENT LOAN INTEREST DEDUCTION RESTORATION COALITION

Introduction

The Student Loan Interest Deduction Restoration Coalition (SLIDRC) consists of 31 national education and health related groups concerned about growing student indebtedness and its impact on access to higher education and post-graduation career choices. Restoring a student loan interest deduction/credit would be a critical step the government could take to assist individuals with high student loan debt. This would especially help middle income families who have to borrow to finance higher education because they do not qualify for grants. We respectfully request that Congress include some type of student loan interest deduction/credit in tax legislation being considered this year, as would be provided in H.R. 1667 and S. 271.

SLIDRC represents thousands of students nationwide struggling with increasing student debt burdens. The examples below describe some of their specific situations.

Examples of Student Debt Situations

* Paul Jung, who is presenting oral testimony for SLIDRC, is a second-year medical student at the University of Maryland at Baltimore. He is also coordinator of the American Medical Student Association's Legislative Affairs Standing Committee. Upon graduation, he expects to owe approximately $70,000 in student loans, which translates into payments averaging $800 per month -- approximately $5600 of interest in the first year of repayment (assuming an interest rate of 8%). Mr. Jung plans to enter a career in public health/preventive medicine. In this field, Board certification requires a 2-year residency and a Master's degree in Public Health. He expects to incur an additional $20,000 in debt to receive his Master's degree. As Mr. Jung plans his career in public health, he also sees other classmates with similar high debt weighing options of higher paying specialties or lower-paying primary care careers. Their debt burden is a serious consideration for decisions about career plans.

* A recent bachelor's degree recipient who testified before the subcommittee in 1990 is typical of students who would benefit from favorable tax treatment of student indebtedness. Her father, a farmer, was in debt due to the failing farm economy, but the value of his farm and land disqualified her from scholarship programs available at her school. As a result, she borrowed nearly $16,000 for educational expenses. However, considering a likely $15,000 to $30,000 in additional borrowing needed to pursue an advanced degree, this potential burden combined with the absence of a tax benefit deterred her from applying.

* A student delayed the start of undergraduate training due to concerns about indebtedness. This is a typical concern for students who do not qualify for grant assistance. While she worked long hours to put herself through school, she still accumulated educational debt. Concern with debt will also be a factor in her decision about seeking additional training.

* A graduate student completing a doctoral degree in the sciences expects to graduate with approximately $60,000 in debt, and hopes to enter a faculty position where starting salary may be as low as $25,000 (which is not unusual for academics).

* A dental student at a private university expects to graduate with $100,000 in debt. His parents were both retired, and he had to finance this education entirely from student loans rather than grants. This student is entering the U.S. Navy as a dentist, but will find it difficult to make ends meet on the low military starting pay combined with high student loan debt.

* A married couple expects to have $100,000 in combined higher education debt. The wife is completing a law degree and wants to work in public interest law. The husband is completing a doctoral degree in english. They worry that it will be difficult for them to pursue these goals given this level of debt. They also worry about "passing on the American dream" to their children when the time comes to finance their children's educational costs.

Background

The 1986 Tax Reform Act phased out the deduction for "consumer" interest over a 5-year period, to discourage over-reliance on credit. Unfortunately, educational loans were also included, even though they are investments in education rather than discretionary consumer borrowing. SLIDRC believes that borrowing for higher education is an investment in human capital which should be treated like other capital investment. Loans used to finance an education contribute to the economic strength of this country in a significant manner.

Current law permits interest deductions for educational expenses paid for through home equity loans. This is not an option for most of the student population, and some families, who either do not own a home or do not have sufficient home equity and therefore cannot benefit from this deduction.

Elimination of the student loan interest deduction especially hurts those students who come from families where there is little or no excess cash to contribute to the student's education, as well as students who are financially independent and not receiving parental support for pursuing a degree.

In recent years there has been increasing reliance on loans to finance a higher education, as grants and scholarships have not kept pace with student needs. For many, a loan is the only means to finance a higher education. Most students have been willing to incur this debt because they see it as an investment in their future financial security and in their potential for social contribution. Loans have dramatically increased from 39% of all federal student aid 20

years ago to 65% in 1990. Among other factors, reductions in public support for state universities combined with shortfalls in the Pell Grant program has led to increased student borrowing.

Recent estimates are that average graduating debt for undergraduates in public four year programs is over $6500, and is over $9500 for private four year programs. Such debt may discourage entry into higher education. A recent study by the Educational Testing Service found that high school seniors who were concerned about borrowing for their education were more likely to delay college, choose lower-priced schools, or not go at all.

Debt is growing for graduate students due to reductions in teaching and research fellowships and stipends. Debts of over $100,000 for health professions students are not unusual. Such debt is a significant burden in the years immediately after graduation. The growing debt burden for students may discourage the pursuit of advanced degrees, especially for disadvantaged and minority students. Such debt may also discourage graduates from taking lower-paying public service, teaching, and research positions.

A few specific examples of increasing graduate and professional school debt burdens are provided below:

Graduate Students (doctoral candidates)-- In 1988, of those with student debt, 37% owed $10,000 or more. By 1991, 42.5% of those with student debt owed $10,000 or more. This was even more dramatic in the social science field (41% with over $15,000 debt) and for minorities in the social sciences (50% of all 1991 African-American and Hispanic doctoral recipients in the social sciences had over $10,000 in debt).

Medical Students-- The median debt at private medical schools rose from $20,000 in 1981-82 to almost $70,000 in 1991-92. At public medical schools this figure was $18,000 in 1981-82, and increased to about $45,000 in 1991-92. In 1984, median minority medical student indebtedness was $27,262. By 1990 this had increased to $50,038. Osteopathic medical student average debt is $79,800, and for underrepresented minorities this figure is $88,600.

Podiatric Medicine-- The national average graduating debt is between $70,000 to $100,000 (a New York Podiatric medical college reports that 90% of their graduates have debt above $100,000).

Law Students-- A recent study found a 270-300% increase in tuition over the past 10 years. This study found that 1989 graduating debt was close to $40,000 at selected private schools, and $20,000 at selected public schools. This represents a dramatic increase in student loan debt over the past 10 years.

Dental Students-- Average graduating debt in 1981 was $22,100, compared to $36,300 in 1985, $43,300 in 1989, and $55,550 in 1992 (with almost one half graduating with debt over $50,000). One private dental school in California reports average 1992 graduating indebtedness of $110,000.

Health professions graduates with high debt may be deterred from careers in primary care as well as careers in a community or public health setting. In recent years anecdotal evidence suggested this was becoming a factor as debt increased. A recent study of medical students found that debt was a more important factor in surgical or specialty choice for students with debt of $75,000 or more (Kassebaum and Szenas, "Relationship between Indebtedness and the Specialty Choices of Graduating Medical Students" 67 Academic Medicine 700 (1992)).

We are particularly concerned with the impact of indebtedness on low income and minority students. A February, 1990 study, "The Impact of Increased Loan Utilization Among Low Family Income Students" (Thomas G. Mortenson, American College Testing Program Student Financial Aid Research Report Series No. 90-1), found that the greatest growth in indebtedness in recent years was among the poorest students. This is based on data from the Pennsylvania Higher Education Assistance Agency and the national College Freshman Norms Survey published by the American Council on Education and UCLA. Recent studies of medical and dental students revealed higher levels of debt for minority students. 20 percent of minority medical students now graduate with debt above $75,000. In 1992, average debt for Hispanic dental school graduates was $58,973, and was $57,817 for African-American students (this is compared to an average debt of $53,474 for white students).

Since the formation of SLIDRC in 1989, we have not been alone in advocating a restoration of this benefit. In addition to several legal commentators[1], most recently this issue was supported in the final report of the National Commission on Responsibilities for Financing Postsecondary Education entitled "Making College Affordable Again".

Importance of a Student Loan Interest Deduction

The interest deduction is especially important for heavily indebted students in the first years after graduation when earnings are low and interest makes up a greater portion of loan repayment. Student loans are generally repaid over ten to twenty-five years, so that the further a student is from graduation, the less interest there will be to deduct at presumably the same time an individual's earnings are increasing.

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[1]e.g. Argrett, "Tax Treatment of Higher Education Expenditures: An Unfair Investment Disincentive", 41 Syracuse Law Review 621 (1990); "Note- Section 163 : Interest Paid on Educational Indebtedness- Past, Present, and Future" 43 Tax Lawyer 1007 (1990); Phillips and Hatfield, "Uncle Sam Gets the Gold Mine- Students Get the Shaft: Federal Tax Treatment of Student Loan Indebtedness", 15 Seton Hall Legislation Journal 249 (1991).

The potential individual benefit depends on the level of indebtedness. SLIDRC has estimated there may be between a $100 and $2500 yearly benefit from a student loan interest deduction. In the case of our witness, Mr. Jung, let us assume he has no further borrowing and that he begins work in a public health position with a salary of $35,000 (adjusted gross income-AGI). He would expect to save over $500 in taxes in his first year of loan repayment, which is probably equivalent to one month's rent.[2] For a student in a similar situation with higher debt ($90,000- a level of debt that Mr. Jung may ultimately reach if he fulfills his career plans), the estimated first year tax savings would be at least $1200. This is probably equal to six months of grocery bills, and in this example the first year interest would exceed 22% of adjusted gross income.

SLIDRC believes that the loss of this deduction is significant, especially for students who accumulate large educational debt. We believe that many individuals with high debt will choose to itemize their deductions if a student loan interest deduction were available. Although the standard deduction has increased in recent years, in many cases of high debt yearly student loan interest payments alone will exceed the standard deduction amount. For example, it is estimated that $5500 in first year interest results from $52,000 borrowed at 11%; this exceeds the 1992 individual standard deduction of $3600. Also, the ability to deduct state and local taxes would be factored into a decision about whether to itemize. Data for 1989 (the most recent year that complete data has been compiled) shows that 30.4% of taxpayers with AGI between $25,000 and $30,000, 44.4% of taxpayers with AGI between $30,000 and $40,000, and 63.1% of taxpayers with AGI between $40,000 and $50,000 *itemize deductions*. It is likely that such individuals with high student loan debt would take advantage of the deduction option if it were available.

While restoring the student loan interest deduction is not the only solution to the growing debt problem, nor the only factor affecting career choices, it will help to make loan repayment more reasonable and allow the graduate his or her full choice of career options. This means entry into fields such as public health, primary care, teaching, and research where earning potential is substantially reduced. Many Deans and Financial Aid Administrators have observed how students have altered their career choices, and ruled out certain options, based on the level of debt they will incur. Students and parents understand the concept of an interest deduction, and how it will help them with loan repayments. A dean of a professional school reported the reservations by a student's parents when they realized that the educational debt was going to be larger than the mortgage on the family house.

In most cases of students and parents with significant higher education debt, it will make sense for them to itemize and thereby achieve greater tax savings from an interest deduction.

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[2]This conservative estimate measures tax savings from an itemized student loan interest deduction as compared to taking a standard deduction of $3600 in 1992. The other assumption is that Mr. Jung will file as single taxpayer and will have no other itemized deductions.

This is particularly true for parents who have several dependent children attending college at the same time. SLIDRC believes that it is essential to have a student loan interest deduction as part of any student debt assistance tax proposal, so that those with the highest debt will be assisted in a meaningful way. However, in order to assist students and parents without sufficient debt to itemize, the legislation supported by SLIDRC also allows the taxpayer an option of choosing a credit for education loan interest. The taxpayer who itemizes can deduct the full amount of qualified higher education interest for the eligible year. The taxpayer who does not itemize can choose the credit, which would be equal to 15% of higher education loan interest, capped at $300 annually.

Description of Legislation in 1992 and 1993

Members of this Committee can help those recent graduates with high debt by passing current legislation to restore a student loan interest deduction. SLIDRC endorses H.R. 1667 and S. 271, legislation that would provide taxpayers with student loan debt a choice between a deduction or a credit for student loan interest in the initial years of loan repayment. H.R. 1667 was introduced by Representatives Cardin and Bunning on April 2, 1993. Senators Boren and Grassley introduced S. 271 on February 2, 1993.

These bills stem from proposals that were considered in Congress last year. Various forms of this legislation were part of a House, Senate, and Conference tax bill (vetoed) in 1992.[3] A summary of this activity is provided below:

> In its FY 1993 budget proposal, the Bush Administration proposed to restore a student loan interest deduction for all loan repayments made on or after July 1, 1992, with no income or time limitation, at an estimated cost of $3.6 billion over 5 years.
>
> On February 27, 1992, the House of Representatives approved tax legislation that included a higher education loan tax credit proposal, at an estimated cost of $400 million over 5 years. This would have provided a tax credit equal to 15% of higher education loan interest, but the total credit could not exceed $300 per year (it would have increased to $500 per year for those whose annual interest exceeded 10% of AGI). Independent students would have received the benefit for the first 5 years (whether or not consecutive) of loan repayment during which they were not at least a half-time student. Parents would have received the benefit for the period their child was at least a half-time student, and the cap would have been applied separately to interest paid for each child in school. The credit would have been phased out for independent students between $30,000 - $55,000 AGI for individual returns, and

[3]Bills endorsed by the coalition in the 102nd Congress were S. 2160, introduced by Senators Grassley and Boren, and H.R. 747, which was introduced by Congressman Schulze.

$50,000 - $75,000 AGI for joint returns. Phase-out ranges for parents were $45,000 - $70,000 AGI individual, and $75,000 - $100,000 AGI joint. The credit would have taken effect for interest paid after December 31, 1991, which would have covered loans borrowed before that date.

On March 13, 1992 the Senate approved tax legislation that included S. 2160, the Boren-Grassley student loan interest deduction/credit proposal, at an estimated cost of $800 million over 5 years. This would have provided taxpayers with a choice of a full interest deduction, or a credit (capped at $300) for those who do not itemize. The benefit would have extended for the first 4 years of repayment, without income limitations. It would have applied to all loans entering repayment after December 31, 1991.

The final student loan interest provision in the Conference tax bill (vetoed by the President on March 20, 1992) was a credit-only benefit that would have allowed a taxpayer who borrowed for higher education expenses to receive a tax credit equal to 25% of annual student loan interest, capped at $400 annually (note: for parents this cap would have applied separately to each child who was a student, as in the original House bill). The credit benefit would have been phased out between $40,000 - $65,000 AGI for individuals, and $60,000 - $85,000 AGI for joint returns. The credit would have been allowed for interest paid that was allocable to the first 48 months that interest accrued on the loan, and it would have applied to all loans entering repayment after December 31, 1991. The estimated revenue loss was $479 million over 5 years.

An interest deduction option is more beneficial for high debt borrowers, and thus more proportionately targeted based on need. In cases of high debt, tax savings from a deduction would be much greater than $400. A credit-only provision without a deduction option is a relatively flat benefit, and not as useful for high debt graduates as an interest deduction. For example, an independent student with $100,000 debt and $40,000 AGI would have received a $300-400 tax savings from the tax credit proposals in 1992, as compared to an estimated $2100 in tax savings from an interest deduction. A credit-only provision capped at a certain level is unfair to students with greater debt; the 1992 conference provision would provide the equivalent benefit to independent students owing $10,000 as well as those owing $100,000.

We hope Congress will maintain its commitment to helping students by passing H.R. 1667/S.271 during the 103rd Congress. Congressional activity in 1992 acknowledged the desirability of reinstating a tax benefit, even if on a more limited basis than was available before the Tax Reform Act of 1986. On behalf of student groups and other organizations representing thousands of students and parents, SLIDRC is once again recommending this measure be implemented in a manner sensitive to minimizing revenue loss to the treasury while helping borrowers with the most need. This is reflected in provisions of H.R. 1667 and S. 271. Further, these bills address all of the concerns raised over proposals considered last year, as described below:

a. Credit/Deduction Option

Issues had been raised concerning the benefit for non-itemizers who have student loan debt. While a tax credit would assist those who do not itemize, in order to reach high debt students and offer an equivalent benefit to the student loan interest deduction, the credit would have to extend to at least $2000 per year to offer similar relief to students with $100,000 debt. H.R. 1667 and S. 271 resolve the issue of itemizers and non-itemizers as these bills would provide an option to take either a credit or a deduction. H.R. 1667 would allow parents to take the appropriate benefit depending on their level of debt, and use the benefit for each of the loans they may take out for their children.

b. Targeted to critical repayment years

The benefit would last for the first 4 years that repayment of interest is required (although it does not necessarily have to be taken in consecutive years), starting when loans go into repayment. This recognizes the difficult period in which earnings are lowest and interest makes up a higher portion of the loan repayment amount. This provides needed assistance to lower and middle income taxpayers. While SLIDRC would like to have deductions available for the entire term of student loans, we view this four year limitation as a reasonable approach to reduce the revenue loss from an unlimited deduction.

c. House bill provides further targeting through income limits

In order to further target the assistance, H.R. 1667 would phase-out the benefit over certain ranges of AGI: $40,000 - $55,000 for individual returns, $60,000 - $90,000 for joint returns ($30,000 - $45,000 for married individuals filing separately). While SLIDRC wants to ensure that all middle income families will be assisted by this provision and recognizes that principal and interest on these student loans can consume much of student/family income, we can accept these income limits as an option to reduce the cost of the legislation.

d. Technical differences between bills can be resolved

The bills have some technical differences than can be resolved in conference. S. 271 provides for an effective date for interest payments after July 1, 1993 for anyone within the first four years of repayment on their student loan. H.R. 1667 provides the benefit for loans entering repayment after December 31, 1993. Thus, the House bill would only cover those who begin repayment after the effective date, while the Senate approach would include those who began repayment before the effective date and are still within their first four years of repayment. SLIDRC supports an effective date that will help as many current graduates struggling with high debt as possible, but given the current fiscal constraints we are willing to accept the provisions in these bills. H.R. 1667 provides that parents can claim the benefit so long as the child they borrowed for is still claimed as a dependent (subject to the four year

limitation), while S. 271 provides that parents can receive this benefit so long as they are claiming a dependent who is also at least a part time student (this is also subject to the four year limitation).

Consistency with President's National Service and Student Loan Reform Proposals

While SLIDRC is pleased with the Administration's support of investment in education, we believe the student loan interest deduction/credit is necessary to complement the new proposals concerning national service and student loan reform. In its testimony before the subcommittee, the Administration did not oppose or support H.R. 1667, but noted that "the Administration has proposed comprehensive reform of the student loan system, which is currently under consideration by Congress." We would like to see H.R. 1667 be a part of Congressional efforts to implement the Administration's effort to make higher education more available and affordable to students. H.R. 1667 compliments, not duplicates, these efforts.

National Service's Purpose is More Limited

The national service proposal, while important, will not solve the problem of indebtedness and its impact on current graduates and those graduating during the next few years. Even if fully funded, it would assist only 150,000 out of the estimated 3.6 million participants in the federally guaranteed student loan programs. Further, proposed grants or loan forgiveness totalling $10,000 would not eliminate borrowing needs for students with high debt. The program also would not directly assist parents who are borrowing for their children's education.

An interest deduction/credit for all recent graduates will help to provide broad-based relief that is complimentary to the new national service effort.

Direct Lending's Income Contingent Repayment Option is not a Substitute for a Tax Benefit

The Administration's proposed income contingent repayment option in the student loan reform proposal has the potential to alleviate burdens for those with high student debts. However, it does not eliminate the need for tax assistance. The legislation being considered in the House and Senate is more limited than the Administration proposal because:

(a) the Senate bill would only authorize a pilot direct loan demonstration program initially; and

(b) both the Senate and House bills would not allow current borrowers and others not participating in direct lending to be eligible for the income contingent repayment option.

This means it is likely that many graduates over the next several years will not benefit from income contingent repayment. Further, even if all borrowers had this option, the exact terms are not known, as they will be developed in regulations. Therefore, it is unclear the extent that students would be helped under this new option, or whether they would choose to take advantage of this type of repayment plan. Further, parents would not be able to take advantage of the income contingent repayment plan option.

The student loan interest deduction/credit would go to work immediately to support this important investment in people. The deduction/credit proposal provides a comprehensive approach to support students and families, complimentary to these other important Administration proposals.

Conclusion

SLIDRC urges that Congress reaffirm its recognition of and commitment to providing this benefit to students and parents by passing student loan interest deduction/credit legislation (H.R. 1667) in 1993. Restoring the deduction is a valid and cost-effective method for the government to encourage investment in higher education. By restoring the student loan interest deduction, the government acknowledges not only the costs incurred in making this investment, but the contribution higher education makes to society at large. Today, when technologic and scientific training is critical to our world competitiveness and as we strive to become more productive as a nation, the need to invest in higher education becomes even more important to the economic future of our country. This is also the type of middle and lower income tax relief and economic incentive that encourages investment in our most important resource: people.

We believe that restoration of a student loan interest deduction/credit is consistent with the desire of President Clinton and the Congress to provide economic relief as well as to enhance the productivity of our nation.

Attachment: List of SLIDRC Organizations

Student Loan Interest Deduction Restoration Coalition
Member Organizations
as of 6/93

Academy of General Dentistry
American Association of Colleges of Nursing
American Association of Colleges of Osteopathic Medicine
American Association of Colleges of Osteopathic Medicine-
Council of Student Council Presidents
American Association of Colleges of Pharmacy
American Association of Colleges of Podiatric Medicine
American Association of Dental Schools
American Association of University Professors
American Bar Association- Section of Legal Education and Admission to the Bar
American Council on Education
American Dental Association
American Medical Student Association
American Medical Women's Association
American Osteopathic Association
American Podiatric Medical Association
American Podiatric Medical Students Association
American Student Assistance
American Student Dental Association
American University of Beirut
Association of American Law Schools
Association of American Medical Colleges
Association of American Veterinary Medical Colleges
Association of Jesuit Colleges and Universities
Committee on Interns and Residents
Education Funding Services, Inc.
Law School Admission Council
National Association for Public Interest Law
National Association of Advisors for the Health Professions
National Association of Graduate and Professional Students
Student Osteopathic Medical Association
United States Student Association

Mr. KOPETSKI. I am pleased to hear that you are going into preventive medicine and I know you will be a great advocate in any community you decide to select.

Why don't we finish the testimony and then we will take questions. Go down to the table.

Mr. Desjardins.

STATEMENT OF ROBERT J. DESJARDINS, CHAIRMAN, TAX AND FISCAL AFFAIRS COMMITTEE, ASSOCIATED GENERAL CONTRACTORS OF AMERICA, AND EXECUTIVE VICE PRESIDENT AND TREASURER, CIANBRO CORP., PITTSFIELD, MAINE

Mr. DESJARDINS. Good afternoon, my name is Robert J. Desjardins and I am executive vice president and treasurer of Cianbro Corp. of Pittsfield, Maine. Cianbro Corp. is one of the larger construction companies currently building projects in the Northeast and Mid-Atlantic States.

I also serve as chairman of the Tax and Fiscal Affairs Committee of the Associated General Contractors of America and I am before you today in that capacity.

AGC is a national trade association comprised of more than 33,000 firms, including 8,000 of America's leading general contracting companies. On behalf of AGC, I welcome the opportunity to testify on the new 1-year rule relating to temporary travel expenses under Internal Revenue Code section 162(a)(2).

AGC believes that the 1-year rule creates a number of reporting as well as filing hardships for both the employee and the employer, contains ambiguous language, was poorly drafted, and will complicate employer/employee relations and increase costs due to lack of any phasein period.

The new 1-year rule on travel expenses creates a number of reporting and filing problems as well as other hardships for both the employer and the employee. This is particularly true in the construction industry where a number of factors make the prediction of personnel requirements extremely uncertain.

The change suddenly rewrites the rules for living expenses incurred on a temporary job away from home. The new law reclassifies many assignments from temporary to indefinite for tax purposes. Once an assignment is expected to exceed 1 year, all reimbursements must be included in the employee's wages.

However, it is very difficult to predict the length of a temporary assignment in the construction industry. Although in my own company our philosophy is to hire employees from an area local to the project, it may be necessary for us to temporarily assign employees with special skills, such as equipment operators, welders and millwrights to the projects if people with these skills are not immediately available.

Once we find people with these skills in a local area, then the temporarily assigned employees are returned to their home area. We cannot predict how much time this will require. The senior management staff required for a project are always long-term Cianbro personnel. These people travel from project to project.

If some members of the senior management staff are not available from the immediate local area, then we temporarily assign people from other areas until local management staff become avail-

able from another project. Again, the length of these assignments is very difficult to predict.

One thing that I can predict is that our assumptions will oftentimes be wrong. Many personnel whose temporary assignment is expected to be less than a year will be extended to more than a year due to unforeseen circumstances.

Similarly, many personnel whose temporary assignment is expected to last beyond a year will be shortened to less than a year due to, again, unforeseen circumstances.

How do we handle these changes? Do we force our employees to amend their previous tax returns? How do we handle two more temporary assignments within 1 year? It is practically impossible for construction companies such as Cianbro to comply with this new law when regulations are not yet written.

The effect of this change is severe and has already burdened the construction industry with greater paperwork and recordkeeping requirements. In addition to the income tax assessed on reimbursements to employees to cover temporary living expenses for assignments in excess of 1 year, the amounts included in wages are subject to FICA and FUTA taxes.

Further, because these assignments are often for the employer's convenience, many employers will now be pressed to gross up their employment wages for the additional tax the employee must pay. In other words, they must make their employees whole for the tax due on the reimbursements now included in their wages.

The responsibility for paying the income tax will fall not on the employee, but rather on the employer. For contracts that we already have in place, it will be impossible for contractors to pass this additional cost on to the client.

In conclusion, the new 1-year rule's impact is substantial and will grow over time. The 1-year rule is the result of an 11th hour search for revenue offsets to pay for conservation incentives in the Energy Policy Act of 1992.

The provision passed into law without benefit of congressional inquiry and hearings and without any regard for the restrictive effects on the ability of construction companies to work freely anywhere in the Nation using employees in the most efficient manner possible. The unfortunate fact remains that a tax is being assessed on a transaction which results in no economic gain for the recipient.

AGC's recommendations are as follows: First: exempt all construction workers from Section 1938 of the Energy Policy Act of 1992. Second: alternately, change the 1-year requirement back to 2 years or at the least to 18 months. This will ease the burden on an industry already strapped with an unemployment rate twice the national average. And third: provide that all construction workers and employees, including engineers, supervisory staff, management personnel and others given temporary assignments are included and would remain eligible, subject to a facts and circumstances test, for the travel expense deduction.

The description prepared by the Joint Tax Committee in its publication, "Description of Miscellaneous Tax Provisions," is too narrow.

I thank you for the opportunity to testify before you today and I would be pleased to answer any questions at the appropriate time.

Mr. KOPETSKI. Thank, Mr. Desjardins.

[The prepared statement follows:]

TESTIMONY OF ROBERT J. DESJARDINS
ASSOCIATED GENERAL CONTRACTORS OF AMERICA

Good afternoon. My name is Robert J. Desjardins and I am the Executive Vice President and Treasurer of Cianbro Corporation of Pittsfield, Maine. Cianbro Corporation is one of the larger construction companies currently building projects in the Northeast and Mid-Atlantic states. I also serve as Chairman of the Tax and Fiscal Affairs Committee of the Associated General Contractors of America and I am before you today in that capacity.

The Associated General Contractors of America (AGC) is a national trade association comprised of more than 33,000 firms, including 8,000 of America's leading general contracting companies. They are engaged in the construction of the nation's commercial buildings, shopping centers, factories, warehouses, highways, bridges, tunnels, airports, water works facilities, multi-family housing projects and site preparation/utilities installation for housing development. Many AGC member firms compete for work in many different states and localities, adding the value of vigorous competition to construction projects in these markets.

On behalf of AGC, I welcome the opportunity to testify on the new one-year rule relating to "temporary" travel expenses under Internal Revenue Code Section 162 (a)(2). AGC believes the new one-year rule:

- creates a number of reporting as well as filing hardships for both the employee and the employer,
- contains ambiguous language, was poorly drafted, and
- will complicate employer/employee relations and increase costs due to the lack of any phase-in period.

AGC respectfully requests that Congress modify Section 1938 of the Energy Policy Act of 1992 so that it does not apply to workers in the construction industry. Alternately, AGC urges Congress to change the requirement back to two years, or at the least, to eighteen months. Specifically, AGC requests that the Chairman continue to include the following proposal among the miscellaneous tax provisions currently being considered:

> **"A proposal to modify section 1938 of the Energy Policy Act of 1992 to allow (subject to a facts and circumstances test) the deductibility of travel expenses incurred away from home by construction workers if the work project lasts longer than one year, but not longer than 24 months; alternately, to provide that section 1938 of that Act does not apply to workers in the construction industry."**

Should Congress choose to extend the deduction period for travel expenses, AGC suggests that all construction workers and employees on temporary assignment remain eligible for the travel expense deduction. Narrowly limiting which construction employees are eligible for the deduction to just "craft workers," for example, is unrealistic and impractical.

Background

The Energy Policy Act of 1992 contained a small provision, included at the eleventh hour as a revenue raiser, which has greatly handicapped the manner in which construction firms, including Cianbro Corporation, conduct business. Quite frequently, projects that involve "temporary" travel last beyond the shorter and more arbitrary 12 month period allowed by the recent Congressional change to Internal Revenue Code Section 162.

In Section 1938 in the Energy Act of 1992, Congress eliminated the prior longstanding rule which generally allowed deductions to employees whose assignments were expected to last, and
actually did last, more than one, but less than two years. Congress has restricted the ability of the construction industry to employ certain workers on projects involving extended periods of travel, generally lasting more than 12 months.

Language contained in the Committee report says, "the new law treats a taxpayer's employment away from home in a single location as indefinite rather than temporary if it exceeds one year. Thus, no deduction would be permitted for travel expenses paid or incurred in connection with such employment. As under prior law, if a taxpayer's employment away from home in a single location lasts for less than one year, whether such employment was temporary or indefinite would be determined on the basis of facts and circumstances."

In its description of the provision, the Joint Committee on Taxation (JCT) {see, *Description of Miscellaneous Tax Proposals* (JCS-8-93), June 16, 1993} severely limited the category of individuals who would not be covered by the change. The JCT description reads, "In the case of taxpayers who are non-clerical and non-management employees in the construction industry, prior law would apply"; that is, the only construction workers to which the changes made by Section 1938 of the Energy Policy Act of 1992 would not apply are "craft workers."

It is AGC's belief that the Joint Tax Committee too narrowly limited its description, and, in fact, should broaden the description to include other construction industry employees, including associated professionals such as engineers, supervisory staff and management who also need to travel and stay on location -- and not just craft workers.

Creates New Reporting and Filing Hardships

The new one year rule on travel expenses creates a number of reporting and filing problems as well as other hardships for both the employer and the employee. This is particularly true in the construction industry where a number of factors make the prediction of personnel requirements extremely uncertain. The change suddenly rewrites the rules for living expenses incurred on a temporary job away from home. The new law reclassifies many assignments from "temporary" to "indefinite" for tax purposes.

Because IRS rules say living expenses may only be deducted while on temporary assignment, this new rule makes some previously deductible expenses nondeductible. Further, because employer reimbursements of these expenses may only be excluded from the employee's wage if they would be deductible by the employee, any reimbursements of these now non-deductible expenses must be included in the employee's W-2. Employers are now required to treat as wages any reimbursements they make to employees to cover temporary living expenses for assignments in excess of a year.

The effect of this change is severe and has already burdened the construction industry with greater paperwork and recordkeeping requirements. In addition to the income tax assessed on reimbursements to employees to cover temporary living expenses for assignments in excess of one year, the amounts included in wages are subject to FICA and FUTA taxes. Further, because these assignments are often for the employer's convenience, many employers will now be pressed to "gross up" their employment wages for the additional tax the employee must pay. In other words, they must make their employees whole for the tax due on the reimbursements now included in their wages. The responsibility for paying the income taxes will fall, not on the employee, but rather on the employer.

Ambiguous Language of the New Rule

Another issue arises from the ambiguity of the language as it applies to an individual's "employment away from home in a single location" for one year or more. This language raises the question of whether an away from home stay at two or more locations is also covered by the new rule. It would seem that if an employee is assigned to one project for eleven months and then is reassigned to second project in another location for eleven more months, the employee would not be subject to the new rule as the assignments in both locales meets the less-than-one-year requirement. Similar issues arise when an employee frequently returns home, or shuttles between job locations.

No Phase-In Period

Once an assignment is expected to exceed one year, all reimbursements after that point must be included in the employee's wages. Employers could even conceivably be required to include all reimbursements made in the calendar year in which the assignment exceeds one year (including those made during any of the first twelve months before the assignment was extended) in the employee's W-2, because during that reporting period they no longer reasonably believed that the assignment would last less than one year.

The effective date of the new law also raises an issue as it relates to employees away from home at the end of 1992. The new law is effective for costs paid or incurred after December 31, 1992. For instance, if an assignment began on March 1, 1992 and was expected to last until September 1, 1993, the new rule would apply to travel expenses paid or incurred in 1993, but not in 1992. Companies will need to carefully consider whether to recall employees who are already on temporary assignment, since their expenses incurred after December 31, 1992 will no longer be deductible if the assignment extends beyond one year. Also, it is next to impossible for companies to comply when the regulations are not yet written.

Some Examples Why AGC Opposes the New One-Year Rule

The experience of my own company, Cianbro Corporation with roughly 1400 employees, illustrates many of the problems which stem from the new one-year rule and are typical of AGC member companies. The following points fairly represent the basis of our opposition to the new one-year rule and the need to revise or return to the old rule.

1) The average time span of Cianbro's jobs are from one to two years.

2) Cianbro Corporation has projects in the following states: Maine, New Hampshire, Vermont, Massachusetts, Connecticut, New York, New Jersey, Maryland, Virginia, and the District of Columbia.

3) Generally, Cianbro employees are hired in the general vicinity of the project--in other words, locally, although some management personnel and individuals with special skills may be temporarily transferred for the life of the project or a portion thereof.

4) Personal concerns of employees on travel (versus moving) including: the time required to sell a home and the potential loss of equity from the sale of property; children in school; health and other considerations of family; the difference in living costs between their home and the project area, etc.

5) Factors affecting the decision to go on travel and the length of an assignment for our personnel temporarily transferred to other locations include:

    a) the local availability (or lack) of skilled employees
    b) unforeseen project conditions, i.e. weather
    c) change orders to the contract
    d) additional work in the area

6) Often the length of assignment is not known for reasons listed above. If the length of the assignment changes from twelve months or under, to over one year and the change spans more than one taxable year, living allowances which were not taxable when paid are recharacterized as being, suddenly, taxable. The employee will then be in the position of filing amended tax returns (federal and state) for the previous year.

This is not only costly and time consuming for the employee, but adds to the complexity and additional stress of being away from home. The employer must also file amended W-2's and federal and state payroll tax returns.

7) The nature of the construction industry, based on Cianbro's experience, is such that oftentimes, local companies for a variety of reasons are unable to bid on particular projects, dictating the need for outside contractors to come into the process. Travel expenses and the need for a longer period of time than twelve months to be temporarily away are necessary to the continued growth and good health of construction companies.

Conclusion

The new one-year rule's impact is substantial and will grow over time. The one-year rule is the result of an eleventh hour search for revenue offsets to pay for "conservation incentives" in the Energy Policy Act of 1992. The provision passed into law without benefit of Congressional inquiry and hearings and without any regard for the restrictive effects on the ability of construction companies to work freely anywhere in the nation using employees in the most efficient manner possible. The unfortunate fact remains that a tax is being assessed on a transaction which results in no economic gain for the recipient.

AGC Recommendations

1) **Exempt <u>all</u> construction workers from Section 1938 of the Energy Policy Act of 1992.**

2) **Alternately, change the one-year requirement back to two years, or at the least, to eighteen months. This will ease the burden on an industry already strapped with an unemployment rate twice the national average.**

3) **Provide that all construction workers and employees, including engineers, supervisory staff, management personnel and others given temporary assignments are included and would <u>remain</u> eligible, subject to a facts and circumstances test, for the travel expense deduction. The description prepared by the Joint Tax Committee in its publication, *Description of Miscellaneous Tax Provisions*, is <u>too</u> narrow.**

Thank you for this opportunity to testify.

STATEMENT OF HON. BILL BREWSTER, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF OKLAHOMA

IN SUPPORT OF CLARIFICATION OF SEC. 6045(E)(3) REAL ESTATE REPORTING COMPLIANCE

I am pleased to see Mr. Morgenroth testifying on behalf of the American Land Tile Association on the issues of 1099–S reporting. As you know, many companies send 1099s to the Internal Revenue Service. It has come to my attention from my constituents that there is a problem with cost distribution for 1099–S real estate reporting because of language currently in the Internal Revenue Code. I would like the Subcommittee to note that this problem is a nationwide problem that is not restricted simply to Pennsylvania.

We all hope that all parties who are required to send information to the Internal Revenue Service do so. In general, Congress recognizes that businesses incur costs associated with this compliance, and allows these businesses to recover their costs.

However, there is currently some confusion as to the compliance costs associated with 1099–S reporting. Mr. Morgenroth points out that members of a particular industry which is regulated at the state level are now unfairly penalized because of confusion regarding the separate charge prohibition in the statute and their need to provide documentation of costs to state regulators. Unregulated settlement service providers, on the other hand, would not encounter these problems. I believe that clarifying this matter will provide additional incentives for compliance. At a minimum, this clarification will rectify an unreasonable situation.

Consequently, I hope to see enactment of this provision.

Mr. KOPETSKI. Mr. Morgenroth.

STATEMENT OF IRVING MORGENROTH, MEMBER, GOVERNMENT AFFAIRS COMMITTEE, AMERICAN LAND TITLE ASSOCIATION, AND EXECUTIVE VICE PRESIDENT AND GENERAL COUNSEL COMMONWEALTH LAND INSURANCE TITLE CO., PHILADELPHIA, PA.

Mr. MORGENROTH. Thank you, Mr. Chairman and members of the committee. My name is Irving Morgenroth. I am executive vice president and general counsel of Commonwealth Land Title Insurance Co.

I am testifying here today on behalf of the American Land Title Association where I serve on the Government Affairs Committee.

We are here today in support of the clarification of Section 6045(e)(3) of the Internal Revenue Code regarding the treatment of the title insurance industry's cost of 1099–S compliance reporting. This clarification is necessary to eliminate a possible ambiguity which arises when title insurers submit fees for closing services to State regulators for review.

While Section 6045(e)(3) prohibits a separate charge for 1099–S reporting, the regulatory process may compel a specific reference to the cost of compliance in order to justify the fee of which it is a component part.

Persons responsible for residential real estate closings are deemed real estate reporting persons under the applicable provisions of the Internal Revenue Code. As of January 1987, such persons were required to provide certain information to the IRS, such as the gross proceeds from the transaction.

Effective January, 1993 real property tax proration amounts are also to be provided. There is a substantial amount of work involved in the preparation of the required form. In addition, the form must be delivered to the seller and submitted to the IRS. This may require reporting by electronic media for real estate reporting persons with a high volume of settlements.

The fee for closing services is intended to compensate real estate reporting persons for supervising and providing services for real estate transactions. These services include such elements as providing the facility at which closings take place, preparing necessary documents, accepting funds to pay off a mortgage and issuing checks through an escrow account.

Compliance with 1099–S reporting represents an additional cost factor which affects the adequacy of these fees.

Lawyers and/or brokers who are responsible for real estate reporting are able to recover the costs of compliance by charging fees which, although incorporating the expenses of 1099–S reporting, do not call attention to such inclusion.

The fees of title insurance companies often must be submitted to the scrutiny of State insurance department regulation. This requires that they call attention to the inclusion of a cost factor for 1099–S reporting in order to obtain approval for a fee adjustment. When this occurs, it may form the basis for an allegation that Section 6045(e)(3) has been violated in that such special consideration of the cost of 1099–S reporting constitutes a prohibited separate charge.

Such an allegation has in fact been made in a recent lawsuit in Pennsylvania in which my company, among others, has been named as a defendant. Thus, while the existing statutory language appears clear on its face, regulated providers of real estate closing services may be facing substantial litigation costs in the absence of language clarifying the intention of Section 6045(e)(3).

It is ironic to contemplate the possibility that a regulated 1099–S reporter, such as a title insurance company, should be prohibited from including in its fee a charge for real estate reporting because the method by which the fee was determined considered the cost of reporting with particularity.

Carried to its logical conclusion, that position discourages regulated providers from competing. It leaves the closing service marketplace to unregulated providers who may charge the consumer whatever the traffic will bear as long as the prohibited charge for real estate reporting is not specifically mentioned.

A similar provision to this was included in the Section 7616 of H.R. 11, the Revenue Act of 1992, which unfortunately was vetoed by President Bush. However, the provision remains necessary to clarify the ability of title companies and agents to include costs associated with 1099–S reporting requirements within their fees. We view this as a technical correction.

Therefore, we hope that this would be considered as clarification of existing law and applied retroactively to the date of enactment of Section 6045(e)(3). The provision has no revenue effect and is truly a technical change. We urge its adoption and would be happy to answer any questions.

Mr. KOPETSKI. Thank you for your testimony.

[The prepared statement follows:]

TESTIMONY OF IRVING MORGENROTH
AMERICAN LAND TITLE ASSOCIATION

Mr. Chairman, members of the Committee, my name is Irving Morgenroth, I am Executive Vice President and General Counsel of Commonwealth Land Title Company, the oldest title insurance company in the world. I am testifying on behalf of the American Land Title Association* where I serve on the Government Affairs Committee. I have experience with one of the issues before the Committee, a clarification of Sec. 6045(e)(3) of the Internal Revenue Code regarding the treatment of the title insurance industry's costs of 1099-S compliance reporting. I am accompanied by Ann vom Eigen, Legislative Counsel of the American Land Title Association.

We are testifying in support of a provision similar to that included in Sec. 7616 of the Conference Report on HR 11, the "Revenue Act of 1992" (H. Rpt. 102-1034), which was vetoed by President Bush. This provision is necessary to clarify the ability of real estate reporting persons to include costs associated with the regulatory burden imposed by the reporting requirement within their fees. The provision has no revenue effect, and is a technical change. Specifically, this provision would revise current Section 6045(e)(3) as follows: **(new language in bold)**

(3) Prohibition of Separate Charge For Filing Return– It shall be unlawful for any real estate reporting person to separately charge any customer for complying with any requirement of paragraph (1). **Nothing in this paragraph shall be construed to prohibit the real estate reporting person from taking into account its costs of complying with such requirement in establishing its charge (other than a separate charge for complying with such requirement) to any customer for performing services in the case of a real estate transaction.**

A brief summary describing the need for this amendment is delineated below. A legislative history and description of current IRS reporting requirements on real estate transactions is also provided. In addition, general background on the particular role of the title insurance industry in real estate reporting is included.

The statutory language requiring change has created particular problems in the state of Pennsylvania because of the conflict between providing information necessary to justify cost recovery charges to state regulators, and problems interpreting the Federal statute. Consequently, a synopsis of Pennsylvania fee and charge filing requirements, and litigation involving that requirement is also described.

Summary

Section 6045(e)(3) requires clarification for several reasons. Depending upon the settlement practice in a given area of the country, title insurance companies and their agents, attorneys, brokers, or other participants, supervise and provide services for closing residential real estate transactions. These services may include such elements as providing facilities at which closings take place, preparing necessary documents, accepting settlement funds in escrow, paying off existing encumbrances and disbursing proceeds. The person responsible for a closing is required to report certain information about the transaction to the IRS. This requires the preparation of a form report (1099-S) for submission to IRS and delivery to the seller and may involve the preparation of data in a sophisticated electronic format.

In 1988, Congress enacted a prohibition against separate charges for compliance with 1099-S reporting requirements. We understand that action to reflect a concern that a direct link between a separate charge on a settlement statement and the reporting requirement could constitute a deterrence to compliance. In so doing, Congress did not direct that the cost of such compliance could not be a factor in the establishment of charges for relevant services.

It is obvious, and appropriate, that, in determining fees, the persons providing such services take into account, among other expense factors, the cost of complying with Federal real estate reporting requirements. To the extent that this process is not otherwise affected by regulations, the expense attributable to 1099-S reporting is an invisible component, even if it is used to justify a fee increase wholly disproportionate to the cost of compliance.

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*The American Land Title Association membership is composed of 2,000 title insurance companies, their agents, independent abstracters and attorneys who search, examine, and insure land titles to protect owners and mortgage lenders against losses from defects in titles. These firms and individuals employ nearly 100,000 individuals and operate in every county in the country.

However, many states regulate title insurance rates and charges by requiring that they be filed with state Insurance commissioners for review and\or approval. These regulations can be very far-reaching, extending not only to premium rates, but to specific fees such as settlement charges. If any fee is to be increased to reflect additional expense, insurers are often required to justify the increase by enumerating included cost factors.

Unfortunately, this procedure, itself a device for consumer protection, can be readily misinterpreted to infer that the fee for a particular closing service, determined in accordance with applicable regulation violates the prohibition of Sec. 6045(e)(3) because the cost of compliance with the reporting requirement was an enumerated component in the regulatory review process.

In Pennsylvania, that Inference has already been proffered in an enterprising lawsuit In which my company, among others, has been named as a defendant.[1] While the existing statutory language appears clear on its face, regulated providers of real estate closing services may be facing substantial litigation costs in the absence of language clarifying the intention of Sec. 6045(e)(3).

In so far as we view this as a technical correction, we would hope that this would be interpreted as a clarification of existing law and therefore apply retroactively to date of enactment of Sec. 6045(e)(3). The clarifying language was offered by Senators Bentsen, Specter, Dixon, and Wofford, as Floor Amendment No. 3230, to Sec. 3006 of Senate-reported HR 11, "The Revenue Act of 1992," and adopted on September 26, 1992. That language was also retained as Sec. 7616 of the Conference Report on HR 11, H. Rpt. 102-1034, which was vetoed by President Bush. Unfortunately, this clarification would have been effective only upon date of enactment. As mentioned before, however, we believe it is important to apply such a clarification retroactively.

Current Law and Legislative History of the 1099-S Reporting Requirement

The Tax Reform Act of 1986 (Sec 1521. P.L. 99-514; I.R.C. Sec. 6045(e)) requires that persons responsible for closing residential real estate transactions report gross proceeds and other information from such transactions to the Internal Revenue Service. The primary obligation for such reporting is placed upon the person (including any attorney or title company) responsible for closing the transaction. Failing such compliance, the mortgage lender, the seller's broker, the buyer's broker, or such other person designated in the applicable regulations, in that order of priority, may become responsible as the "real estate reporting person."

The Service issued temporary regulations (§ 1.6045-3T) implementing this provision applicable for transactions from January 1, 1987 to December 30, 1990 inclusive.

The Technical and Miscellaneous Revenue Act of 1988 (P.L.- 100-647) included a provision (Sec. 1015(e)(2)(A), I.R.C. Sec. 6045(e)(3)), prohibiting a separate charge for the preparation of Form 1099-S in connection with a closing. That law became effective in November, 1988.

Final regulations were issued in December, 1990 (55 F.R. No. 240, 51282, December 13, 1990). The regulations require the real estate reporting person to supply the seller in such transaction with a Form 1099-S, indicating the substance of information furnished to the Internal Revenue Service.

An additional information reporting requirement requiring real estate reporting persons to report real property tax proration amounts, to the IRS was included in Sec. 1939 of the "Energy Policy Act of 1992." (P.L.- 102-486). These real property tax proration amounts are an adjustment made at the time of a real estate closing, to take into account a net payment made by the buyer to the seller of a property to compensate the seller for real property tax payments already made for the time when the buyer will be in possession of a property. The IRS issued interim guidance on this provision in January, 1993. (Notice 93-4, 1993-4 I.R.B. 7, January 25, 1993.)

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[1]. Burns et al. v. Commonwealth Land Title Insurance Company, et al., D.C.(Eastern District of Pennsylvania), C.A. No 91-1812

Though clarification of I.R.C. Sec. 6045(e)(3) regarding the separate charge was agreed to by Congress as Sec. 7616 of the Conference Report on HR 11, "The Revenue Act of 1992," President Bush vetoed the bill. Therefore, it remains necessary to establish that while 6045(e)(3) prohibits separate charges for 1099-S filings, it does not prohibit combined charges or other means of recovering compliance costs.

Title Insurance and Real Estate Reporting

The primary function of title insurance companies and agents is the issuance of title insurance. For a one-time premium at the real estate closing, title insurance will identify title problems found in a search of public records, pay valid claims, and pay for defending against an attack on title as insured. Title insurance premium rates cover these comprehensive searches, and the probability that litigation and other costs leading to losses may arise. These rates have traditionally been set by pooling risks and establishing a premium schedule which depends on the value of the property, in effect the principal at risk, and the nature of the interest to be insured. Title insurance companies or agents who provide services beyond writing insurance, e.g.; perform real estate closings, are also likely to charge fees for particular services associated with the transaction, e.g., settlement fees, escrow fees, and/or disbursement fees. Like other insurance products regulated by the states, premium rates are regulated at the state level. Also, settlement service fees are often regulated at the state level, and are covered by federal and state consumer disclosure laws.

Title insurance companies and their agents are often real estate reporting person and responsible for compliance with Sec. 6045(e). In order to recoup the cost of such compliance, these entities must obtain regulatory approval through a procedure which compels that the expense of 1099-S reporting be disclosed as a specific factor in the calculation of the proposed charge. Unless the costs of real estate reporting are to burden the financial condition of title insurers, the very process by which fees and charges are regulated causes substantial confusion in the light of the prohibition contained by Sec. 6045(e)(3). Pennsylvania is an excellent example of this problem.

Pennsylvania Rate Regulation

In Pennsylvania, the person responsible for a closing is a title insurance company, an agent for a title insurance company, or an attorney. In about 1960, the title insurance industry in Pennsylvania set up and, in compliance with state law, had approved, a disbursement fee which included nominal charges based on the number of disbursement items. Accordingly, after enactment of the 1986 Tax Reform Act, in early 1987, title insurance companies filed proposals with the Pennsylvania Department of Insurance to add an additional item to the disbursement charge. This filing requirement is specified under Pennsylvania law (40 P.S. 910-37). Companies and agents proposed to increase the per transaction charge to cover additional costs for filing Forms 1099-S, such as revising closing procedures, employing computer programming and computer system specialists, and arranging for a separate operation to produce required forms and tapes. A copy of one company's justification for those charges, which was filed with the Pennsylvania Department of Insurance in early 1987, is available for Committee review if desired. These charges became effective during 1987, in compliance with statutory requirements.

Subsequent to the adoption by the industry of these disbursement charges, Section 6045(e)(3) was promulgated in the Technical Corrections Act of 1988, which became effective in late 1988. As noted above, that provision prohibits a separate charge for the preparation of Form 1099-S in connection with a closing. There is now a dispute about the precise meaning of Sec. 6045(e)(3). It is being argued that this provision can not be interpreted to allow the cost of real estate reporting to be recovered as one of the items under a combined charge for related services.

Pennsylvania Litigation

In March, 1990 a class action suit was filed against Commonwealth, and other title insurance companies and agents in Pennsylvania, alleging that the defendants were charging and collecting a fee in violation of the federal statute. This matter has been under litigation in both state and Federal courts, primarily on jurisdictional grounds, although it should be noted that the District Court has agreed with the defendants that "the term separately charge must be given its literal interpretation".

We are unaware of any additional instances where private parties believe they have authority to enforce the Internal Revenue Code. We hope that the Subcommittee considers that the current litigation is obviously financially burdensome, and that proliferation of this type of action on a national level, covering the 5 to 7 million annual real estate transactions would present a financially devastating picture. This litigation is one precedent-setting instance which supports the need for clarifying language.

Consumer Protection Issues

The Real Estate Settlement Procedures Act (12 U.S.C. Sec. 601 et seq.) has focused public attention on settlement costs with significant disclosure rules that require all charges by providers of settlement services, whether imposed on the buyer or seller, to be "conspicuously and clearly" itemized in the HUD-1 settlement statement. Also prospective homebuyers are furnished with information regarding the range of charges made by local providers to assist them in "shopping" for settlement services.

In addition, a variety of state consumer protection laws exist to eliminate egregious or fraudulent practices, but, in the last analysis, market pressures and competition among providers of closing services tend to offer the only real protection to the homebuyer.

However, as in every business, increases in cost tend to trigger price increases. If the provider is not regulated, e.g. lawyers and brokers fees, market factors may not be enough to prevent the escalation of the market price to a point well in excess of the increased costs. In many areas, title insurance companies and their agents, by competing in the marketplace serve as a brake to price escalation because of the scrutiny to which all of their fees are subjected by state regulators.

No one argues that 1099-S reporting does not impose additional costs on providers who must comply, although the extent of the cost increase may vary with local settlement practice and the volume of the provider. These costs can become more significant if a provider is required to report by electronic media. It would also be unreasonable to suggest that the fees of a real estate reporting person should not reflect all of the expenses of operation, including 1099-S reporting.

It is ironic to contemplate the possibility that a regulated 1099-S reporter, such as a title insurance company, should be prohibited from including, in its fee, a charge for real estate reporting because the method by which the fee was determined considered the cost of reporting with particularity. Carried to its logical conclusion that position discourages regulated providers from competing and leaves the closing service marketplace to unregulated providers who may charge the consumer whatever the traffic will bear as long as the prohibited charge for real estate reporting is not specifically mentioned.

Conclusion

In conclusion, we hope the Committee sees the need to clarify the ability of real estate reporting persons to include information reporting costs within overall fees. We appreciate the Committee's attention to this matter, and would be happy to respond to any questions.

Mr. KOPETSKI. We will hear from Mr. Martello.

STATEMENT OF MICHAEL E. MARTELLO, CHAIRMAN, TAX COMMITTEE, NATIONAL CONSTRUCTION ASSOCIATION, AND ASSISTANT CONTROLLER AND MANAGER OF TAXES, BECHTEL CONSTRUCTION COMPANY, SAN FRANCISCO, CALIF.

Mr. MARTELLO. Mr. Chairman and members of the committee, my name is Michael Martello. I am the assistant controller and manager of taxes for Bechtel Construction Co. in San Francisco.

I appear before you today in my capacity as chairman of the tax committee for the National Constructors Association. On behalf of NCA, I am pleased to have the opportunity to testify before this subcommittee today on the deductibility of expenses incurred by construction workers while on temporary assignment. This is a significant issue for my company as well as other members of NCA.

Given that there was no opportunity for comment last year on this provision, we are very pleased that the subcommittee is examining the impact of Section 1938 of the Energy Policy Act of 1992 on the construction industry.

NCA is comprised of many of the Nation's foremost firms engaged in the design, engineering and construction of major industrial, commercial and process facilities worldwide. NCA member companies collectively place thousands of professional, technical and clerical skilled craftsmen on temporary assignments around the world. These employees include construction managers, safety experts, engineers, accountants and other support staff.

Mr. Chairman, my testimony today will focus on the impact of this legislation, particularly its retroactive application to assignments begun before 1993 and also on proposals also to modify this provision. Specifically, NCA believes that the new 1-year rule fails to recognize the importance of work force mobility in the construction industry and it creates an administrative burden for the professionals who staff the projects.

It also unfairly provides no transition period for projects staffed under prior law, and includes ambiguous language which is difficult for both the employers and the employees to interpret in the absence of congressional clarification or, in the alternative, IRS interpretation.

Finally, it will impede recruitment, further complicate work site scheduling, and impose financial hardships on employees and/or their employers.

Some background on the construction industry may help improve the understanding of the unique impact of this provision. Unlike other industries where employment is relatively stable and employees report to work at the same fixed location for the most of their working careers, construction employers have no control over where a particular facility will be located.

In many instances, work sites are located in remote and obscure areas or in areas where technical and skilled manpower is either unavailable or in short supply. There are many different short-term phases of any one particular construction project that require employees to work away from their tax home and where permanent relocation is not economically feasible. These phases include start-

up, initial procurement, plant modifications, and expansions and pipeline construction.

Staffing these projects with personnel who have the needed technical and managerial experience is crucial to fulfilling the contractual obligations that a construction company has to its client.

There are many times when projects are delayed for unanticipated or uncontrollable reasons. For example, projects are typically delayed due to adverse weather conditions, equipment failure, project scope changes, delays in materials delivery, lack of financing to complete the work, unforeseen environmental and occupational hazards, and acts of God, such as Hurricane Andrew and floods like we are currently experiencing in the Midwest, which will obviously delay hundreds of construction projects. The new law as written makes no allowances for these circumstances.

NCA would also like to stress today that the retroactive application of Section 1938 to assignments, which began in 1992 and continued into 1993, is a particularly unfair and burdensome interpretation of the statutory language which we believe merits review and revision.

NCA hopes that the Treasury Department will adopt reasonable transition rules to alleviate the burden created by this provision. However, NCA believes that Congress should take the affirmative steps necessary to remedy this hardship. We urge the subcommittee to take action to ensure that prior law applies to assignments that were begun in 1992.

My formal written statement contains some examples of the practical effect of the change to Section 162 that will demonstrate the reasons for our companies' concerns. Two companies reported that they have at the present approximately 300 employees on temporary assignment for more than 1 year. They estimate the cost of this law change will range from $1.5 to $4.3 million per year.

Construction employers have not been afforded the opportunity to incorporate the cost of additional employment taxes into fixed price contracts or choose alternative staffing methods to offset the negative impact of Section 1938. Some transition period or special provisions for the construction industry are badly needed and clearly justified.

NCA fully supports an extension of the 12-month period to 18 months or an exemption for all construction employees. The description of a proposal conveyed by the Joint Tax Committee's staff set forth two alternatives for consideration, that prior law would apply to nonclerical and nonmanagement employees or an 18-month period would be applicable to the construction industry.

We believe the description in the first proposal should be broadened to include all engineers, technicians, supervisors and project managers who happen to be needed at the job site.

In summary, NCA believes that Section 1938 is extremely injurious to the construction industry. Maintaining a pool of qualified, highly mobile personnel is critical to our international competitiveness. In addition, it is critical to maintaining the health and vitality of one of our Nation's most valuable assets.

Much work needs to be done to rebuild our Nation's infrastructure, clean up hazardous waste sites, rebuild defense bases for civilian use and better equip U.S. industry for the competitive chal-

lenges of the 21st century. Future construction needs, both of private industry and Federal and State Governments, will not be well served by tax provisions which impede mobility and increase costs.

So, on behalf of NCA, I thank the subcommittee again for affording us the opportunity to share our concerns. We look forward to working with the subcommittee and would be happy to provide you with any additional information on how this provision affects our industry.

Mr. KOPETSKI. Thank you, Mr. Martello.

[The prepared statement follows:]

TESTIMONY OF MICHAEL E. MARTELLO
NATIONAL CONSTRUCTORS ASSOCIATION

The National Constructors Association is pleased to have the opportunity to testify before the subcommittee today on the deductibility of travel expenses incurred by construction workers while on temporary assignment. Given that there was no opportunity for comment last year on this provision that so gravely affects our industry, we are very pleased that the subcommittee is examining the impact on the construction industry of Section 1938 of the Energy Policy Act of 1992, as it amends IRC Section 162(a)(2).

NCA is comprised of many of the nation's foremost firms engaged in the design, engineering and construction of major industrial, commercial and process facilities worldwide. In 1992, NCA member companies collectively placed thousands of professional, technical, clerical and skilled craftsmen on temporary assignments around the world to meet the ever-changing demands of the engineering-construction market. These employees include construction managers, safety experts, engineers, accountants and other support staff.

NCA's testimony today will focus on the impact of this legislation as written, particularly its retroactive application to assignments begun during 1992, and will also comment on proposals to modify the provision. Specifically, NCA believes the new one-year rule as enacted:

- Fails to recognize the importance of workforce mobility in the construction industry;
- Creates an administrative burden for the professionals who staff projects;
- Unfairly provides no transition period for projects staffed under prior law;
- Includes ambiguous language which is difficult for both employers and employees to interpret in the absence of congressional clarification or IRS interpretation;
- Will impede recruitment, further complicate worksite scheduling and impose financial hardships on employees and/or their employers.

THE NATURE OF THE CONSTRUCTION INDUSTRY

Some background on the construction industry may help improve understanding of the unique impact of this provision on the industry. Unlike other industries where employment is relatively stable and employees report to work at the same fixed location for the majority of their working careers, construction employers have no control over where a facility will be located. In many instances, worksites are located in remote and obscure areas, or in areas where technical and skilled manpower is either unavailable or in short supply. This requires employers to import labor from other areas and reassign "home office" personnel to these projects.

As the subcommittee considers the importance of allowing an amendment to Section 1938 to deal with the unique problems of construction workers, it is important to understand why temporary assignments are critical to the industry. There are many different phases of any one construction project that require employees to work away from their home office where permanent relocation is not economically feasible, such as start-up, initial procurement, plant modifications and expansions, and pipeline construction. Many of these phases are of limited and unknown duration, depending on the nature of the project. Staffing these

projects with personnel who have the needed technical and managerial experience is crucial to fulfilling the contractual obligation a construction company has to its client.

To further complicate the estimation of how long these temporary assignments will last, there are many times when projects are delayed for unanticipated or uncontrollable reasons. For example, projects are typically delayed due to poor weather conditions; equipment failure; owner changes and/or deceleration orders; delays in materials delivery; lack of financing to complete work; unforeseen environmental and occupational hazards; earthquakes, hurricanes and other acts of God. Under the new law, any one of these instances could cause an employee to lose the deduction of travel expenses during his entire assignment if circumstances beyond his control forced him to stay at the project beyond a 12-month period. In most cases, assignments are only extended because it would be too costly to replace the employee or when a replacement would further disrupt the project schedule.

IMPACT ON CRAFT WORKERS

We have examined the economic effects of the amendments to IRS Section 162(a)(2) on specific NCA company operations and have provided some examples of the impact in this testimony. However, our examination focuses entirely on the impact on our companies' direct hire employees and does not quantify the impact on the thousands of skilled craftsmen which union companies such as NCA member companies recruit for temporary employment. NCA companies used approximately 130,000 skilled union craftsmen in 1992. Some of this workforce would definitely have received temporary assignment expenses because of their work away from home. The nature of the industry is that these workers would be brought in for assignments lasting from a few months to one year as the needs of the project dictate. We cannot estimate the impact of the changes in Section 162 on the availability of these workers or the costs of utilizing them, but we can speculate that the change will disrupt recruitment and may necessitate a review of per diem policies as set forth in union agreements.

MOBILITY AND JOB CREATION

Limiting the deductibility of travel expenses while away from home to a 12-month period severely restricts the mobility of the construction workforce at a time when sluggish economic growth dictates that every effort should be made to create new jobs. Section 1938 clearly has a disproportionate impact on the construction industry. And it is important to note that the employees affected by this law change are generally not highly-compensated employees, but are part of the skilled critical workforce that is the backbone of the industry.

RETROACTIVE EFFECT

In addition to the unique impact on the construction industry, NCA would like to stress today that the retroactive application of Section 1938 to assignments which began in 1992 and continued into 1993 is a particularly unfair and burdensome interpretation of the statutory language which we believe merits review and revision. NCA was particularly disappointed that recent guidance on regulations to be implemented by the Treasury Department (IRS Notice 93-29) stated that travel expenses paid or incurred in 1993 while away from home for more than one year are non-deductible even if such period began in 1992. In letters to Judith Dunn, Deputy Tax Legislative Counsel, and the IRS, NCA stressed that this interpretation fails to take into account that many construction contracts are obtained under lump sum terms and

staffed in accordance with rules in effect prior to January 1, 1993. We hope the Treasury Department will adopt reasonable transition rules to alleviate the burden created by this provision, which was enacted without warning and was clearly not intended to correct any deficiency in the law. However, NCA believes that Congress should consider the increased hardship imposed on construction employees who are more heavily burdened by this provision than persons in any other profession and should take the affirmative steps necessary to remedy this hardship.

We urge the subcommittee to take action to ensure that prior law applies to assignments begun in 1992.

ECONOMIC IMPLICATIONS OF THE NEW ONE-YEAR RULE

To substantiate the need to remedy the changes to Section 162, several NCA companies have offered information regarding temporary assignments which helps to illustrate the practical and economic implications of Section 1938:

- At any given time, one company has approximately 1,500 employees on temporary assignments. As of May 1993, 306 of those employees were on temporary assignments which began prior to 1993 and are scheduled to last between 12 and 24 months. Grandfathering rules should be provided for such assignments since the employees, employer and clients all made commitments prior to the law change, relying on the then existing law.

- The average temporary assignment cost for travel to and from the site, lodging, meals and incidentals is approximately $1,750 per month per employee. If the employee is reimbursed his or her costs, but not "grossed up" for tax, the employee's additional tax cost due to the change in law is approximately $700 per month. If the employee is "grossed up", the additional cost to the employer is $1,166 per month. On an annual basis, this is an $8,400 cost to the employee or $14,000 additional cost to the employer, per employee.

- If this company is to keep its 306 employees whole for duplicate living expenses incurred while on temporary assignment of more than 1 year but less than 2 years, it will cost approximately $4.3 million per year. This is a "no value added cost" of providing construction services.

- On project A, there were approximately 35 engineers initially assigned to a client's project for a period of 12 months or less. The design completion was unexpectedly extended by the client who required that three of the key engineers be retained on the client's project to support their efforts for an additional three months in 1993. Under a retroactive application of the law, the additional tax cost to each employee would be $10,500, or an effective tax at a confiscatory rate of 200% on the $5,250 of living expenses provided for the additional three months. If the employee is to be kept whole, the employer's additional cost per employee would be $17,500 or an effective tax rate of 333%. Surely, this can't be the result intended by the Ways and Means Committee or its Senate Finance counterpart when this provision was adopted.

- Another company stated that, assuming a tax bracket of 28%, an average per diem of $40, a monthly car allowance of $400, a monthly home visit allowance of $500, the employee would be expected to absorb approximately $600 for each month of an extended temporary assignment. In addition to this monthly amount, there would be a one-

time demobilization cost (shipment of belongings, lease cancellation, travel expenses) for which an employee would be expected to absorb anywhere from $500 - $1,300.

- Of the 200 employees this company reported to be currently on temporary assignment, 18 of them (9%) are nearing the 12-month arbitrary cut-off. Under the new temporary assignment provision, these 18 employees would bear a total cost of approximately $10,800 per month, plus the one-time demobilization costs equal to $9,000 - $23,000. Assuming an average assignment extension of 3 months, the total tax liability would equal $41,400 - $55,400. If the company opted to gross up the expenditures for the employees, the cost to the company would approach $85,000.

- At the beginning of January, 1993, one company had 300 employees on temporary assignment for a period of over one year; 215 of these employees were on two major projects. Using a per diem rate of $45 per day (paid by that company in that area), 7 days a week, and a 30% tax rate, the cost of this law change to the 300 employees would total $1.5 million or $5,000 per employee.

- An alternative cost to the company which is difficult to calculate, but nevertheless real, results from the increased recruitment costs and/or decreased productivity which could be expected to follow implementation of this provision. It will be increasingly difficult to entice people to take jobs where they are separated from their families, considering the increased taxes which they will would have to pay for the privilege of working these assignments. Severe delays or work disruptions could result from having to rely exclusively on the local pool of workers which may be less qualified and available in insufficient numbers to meet the project needs.

NCA's RECOMMENDATIONS

Construction employers have not been afforded the opportunity to incorporate the cost of additional employment taxes into fixed price contracts or choose alternative staffing methods to offset the negative impact of Section 1938. Some transition period or special provisions for the construction industry are badly needed and clearly justified.

NCA fully supports an 18-month period or construction employee exemption. A description of proposals conveyed by the Joint Tax Committee staff (JCS-8-93) on June 16, 1993, set forth two alternatives for consideration: 1) that prior law would apply to non-clerical and non-management employees, or 2) an 18-month period would be applicable to the construction industry only. We believe the description in the first proposal should be broadened to include engineers, technicians, supervisors and project managers who are needed at the job site.

CONCLUSION

In summary, NCA believes that Section 1938 as enacted is extremely injurious to the construction industry. Maintaining a pool of qualified, highly mobile personnel is critical to our international competitiveness. In addition, it is critical to maintaining the health and vitality of one of our nation's most valuable assets. Much work needs to be done to rebuild our nation's infrastructure, cleanup of hazardous waste sites, rebuild defense bases for civilian use, and better equip U.S. industry for the competitive challenges of the 21st century. Future

construction needs, both of private industry and federal and state governments, will not be well served by tax provisions which impede mobility and increase costs.

NCA has asked the IRS to consider exceptions to the statutory deadlines provided in Section 1938 where acts of God or other uncontrollable circumstances have extended assignments, and hopes that the IRS will adopt fair and workable regulations. However, NCA believes that congressional action is both necessary and warranted to prevent the law from harming one of our nation's most vital industries.

On behalf of NCA, I thank the subcommittee again for affording us the opportunity to share our concerns. We look forward to working with the subcommittee and would be happy to provide you with any additional information on how this provision affects our industry.

Mr. KOPETSKI. We will go to the questions now. I want to say to Mr. Jung that I am a cosponsor of Congressman Cardin's piece of legislation, and although we do have a fine medical school in the State of Oregon, I am a cosponsor because some Oregon State University veterinary students pointed out this legislation and suggested I get on the bill. So it is not just medical students, but dogs and cats and cow doctors as well.

Mr. Cardin.

Mr. CARDIN. We are going to look for some schools in Virginia and get Mr. Payne as a Member on the bill.

Thank you, Mr. Chairman.

Mr. Jung, again, I appreciate your testimony. You mentioned in your statement and you mentioned also in your oral presentation about the February 1990 study on "Impact of Increased Loan Utilization Among Low Family Income Students," and that—I guess it is not surprising, but I guess the conclusion is that lower income people will graduate from colleges with higher debt than higher income people.

Mr. JUNG. Yes, because they have less money to pay for college or medical school or anything. They take out more loans and so when they graduate, they have more loans to pay off.

Mr. CARDIN. The impact of this legislation will really help those who are most in need. The lower income people will benefit more because they have larger debt and more interest charges.

Mr. JUNG. Yes.

Mr. CARDIN. And they have a more difficult time paying back those loans and have the interest for a longer period of time?

Mr. JUNG. Yes. They have the most loans and this deduction will help them the most.

Mr. CARDIN. As has been pointed out, this bill applies beyond just medical schools, but while I have you here, I must ask this one question. Medical students today are graduating with larger and larger debt.

In your case it is going to be somewhere between $70,000 to $90,000. If you go on into primary health care, it is even more expensive, some of the training you are going to need, the large debt, the fact that the interest on that debt will not be deductible. You have to use your after-tax income to do it.

Is it affecting medical students' decisions as to what field of medicine that they will actually enter into? May they go into a field that they would prefer not to in order to be in a better position to repay those loans?

Mr. JUNG. Many of my friends in medical school, when we first started, we were all interested in going into primary care, public health, that sort of thing. But as we go through school and we get periodic reminders of how much we owe and how much we have to take out in loans next year, and we see upper classmen graduating and going into high paying specialties and paying off their loans 1 year after entering private practice, it is pretty obvious to us that it is a lot easier to go into a higher paying specialty to pay off everything than to go into primary care, and some of my friends have made that choice.

Mr. CARDIN. Well, I want to congratulate you not only for being here, but for sticking to your convictions and sticking with primary

health care. We need you in that field and I encourage you to continue in those efforts.

Mr. JUNG. Thank you, sir.

Mr. KOPETSKI. Mr. Payne may inquire.

Mr. PAYNE. Thank you very much, Mr. Chairman.

Mr. Jung, I too want to commend you for considering primary health. One of the institutions in my district is the University of Virginia and the University of Virginia Medical School. That school is now looking at ways that it can graduate 50 percent of their physicians as primary care physicians by the year 2000.

So we are very interested in that from a public policy perspective and admire you very much for that and, Ben, I will look at your bill. I haven't had an opportunity to do that yet, but thank you very much for calling that to my attention.

I just had a couple of questions for Mr. Desjardins and Mr. Martello. Could you tell me how many people in your firm are at any one time are traveling or in a temporary residency status?

Mr. DESJARDINS. Sure. We have approximately 1,400 employees and it does vary from time to time, but approximately 200 of those would be on temporary travel, eligible for per diem because of a temporary assignment away from home.

Mr. PAYNE. What about Bechtel?

Mr. MARTELLO. We have about 1,500 employees on temporary assignment at any point in time and there are about 300 who would be negatively impacted by shortening the period to 1 year.

Mr. PAYNE. So you are saying not only are they traveling at any one time, but they would be affected by the 1-year rule?

Mr. MARTELLO. Oh, yes.

Mr. PAYNE. 300 of your 1,500 employees?

Mr. MARTELLO. That is right.

Mr. PAYNE. Do you have any idea how many people might be affected by this in the construction industry?

Mr. DESJARDINS. I certainly do not have that information with me today, but I am sure we would be willing to put something together and provide it to the subcommittee.

Mr. PAYNE. If that would be possible for the committee, I would appreciate it. What actions do you foresee if this rule continues? Would you change the way that you do business in order to accommodate this rule?

Mr. MARTELLO. We might develop some very inefficient procedures like bringing people back after 11 months and sending other people out there. This would be very inefficient, but those are the kind of things we might consider if we can't get reimbursed from our clients for extending any particular person's assignment beyond the 12-month period.

Mr. DESJARDINS. I would agree with that. I think the first approach would be to find ways to keep the assignment less than 12 months. It is difficult now because of the retroactive nature of the law. It goes back to the prior year.

Short of that, I think we would have to look at, for those people that we can't keep under 12 months, passing that as an additional cost on to the clients. All of the contracts we have under way now have no provision whereby we can pass that additional cost on to the client. Therefore that cost comes out of our bottom line, our

company's bottom line, but in the future I see that increasing the cost of construction to those companies that have people that travel.

Mr. PAYNE. You both mentioned that one of the solutions for dealing with this would be to change the 12 months to 18 months. Would that largely solve the problem?

Mr. MARTELLO. I think that would go a long way.

Mr. DESJARDINS. It certainly would. Of course, our first choice is to leave it at the 24 months. 18 months would certainly help.

Mr. PAYNE. Well, I think it is unfortunate that there never was an opportunity for you to testify before this became law. I am pleased you are here today.

I think your testimony will be very helpful to the committee and I look forward to continuing to look at this issue as we move forward with this legislation.

Thank you, Mr. Chairman.

Mr. KOPETSKI. Let me ask, are there other industries that—not just the construction industry—where there is this kind of mobility involved here? Should we limit this kind of an exception to the construction industry?

Mr. MARTELLO. I don't know that we should limit it necessarily, but I know we are probably the most negatively impacted by this. I had heard about the nurses as well, but as you can see, the construction industry is the only group represented here today.

Mr. KOPETSKI. Do you think there are any particular problems that IRS may have in deciding who is a construction industry and who isn't and have you thought of any possible ways they could minimize these kinds of problems?

Mr. MARTELLO. Construction is construction. I don't know. I guess a business could try to define itself as construction, but——

Mr. KOPETSKI. Until you get to the IRS and then they tend to have different definitions. Let me give you an example. You are building a highway and you put in the landscaping. Is that construction or is it landscaping? If we sat down and thought about it, I am sure we will get into all kinds of examples of where we draw the line.

Mr. DESJARDINS. You could get into some gray areas. I think one of the suggestions was to either increase the time from the 12 months back to 18 or 24.

I guess my understanding is that would apply to all people who travel, not just construction. I am sure that would be broader based than just construction.

Mr. KOPETSKI. Under the prior law it was more than just the time period. There were particular facts and circumstances that had to be met. Is your testimony that you want just the time or you want those time and circumstances?

Mr. DESJARDINS. The facts and circumstances test has been fine in the past.

Mr. MARTELLO. Existing law has worked fine because it is subjective, based on the particular facts and circumstances, not just an arbitrary time period cutoff.

Mr. KOPETSKI. OK, thank you. Do you have any questions?

Mr. PAYNE. Nothing further.

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Mr. KOPETSKI. Let me ask Mr. Morgenroth, your testimony indicates that the consumers have sued certain land title agencies, including your own, over the imposition of a charge for the required tax reporting.

Approximately how much do you currently charge per transaction for such reporting?

Mr. MORGENROTH. Well, in point of fact, we don't charge separately for such reporting, but in fixing a fee for the general services which incorporate the reporting, a number of companies went to the State regulator in Pennsylvania and in consideration of that process justified their fee by explaining that part of that cost was approximately a $7.50 cost for that particular aspect of the service.

As a result of that, that was determined by some claimants to be a separate charge, although it is simply an itemized thing that is required to be done in connection with the very process of rate-making in the State regulatory process.

Mr. KOPETSKI. If there is any kind of magnetic media, if you are required to report on magnetic media?

Mr. MORGENROTH. If you exceed a threshold of volume, I believe it is something like 250 cases a year.

Mr. KOPETSKI. I see. Well, I don't see anybody else that has any questions here and so I am going to adjourn the hearing.

[Whereupon, at 3:25 p.m., the hearing was adjourned.]

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